AUDITS OF CONSTRUCTION CONTRACTORS

AN AICPA INDUSTRY AUDIT GUIDE

Prepared by the Committee on Contractor Accounting and Auditing and the Committee on Co-operation with Surety Companies of the American Institute of Certified Public Accountants

Notice to Readers

This bulletin is published for the information and assistance of members of the American Institute of Certified Public Accountants and others interested in the subject. It presents the views of the members of the committees that prepared the separate publications contained herein. Since it has not been considered and acted upon by the Council of the Institute, it does not represent an official position of the Institute.

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Foreword to Audit Guide

This booklet has been prepared to combine in one convenient place two booklets issued separately by the committee on co-operation with surety companies in 1959, and to present "specimen" financial statements for construction contractors, prepared by the 1964-65 committee on contractor accounting and auditing. The two earlier booklets were entitled:

a. Generally Accepted Accounting Principles for Contractors
b. Auditing in the Construction Industry

They are reprinted here without change, except for page numbers and deletion of the separate tables of contents.

The specimen financial statements are new material and are presented in the form of two long-form audit reports: one based on a contractor using the *percentage of completion* method; the other based on a contractor using the *completed contract* method.

It is believed these sample audit reports will be useful to members of the accounting profession and to those who read their reports. They are, of course, illustrative only and are intended to be considered as a guide to the accountant in the preparation of contractor financial statements or long-form reports.

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Section I

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR CONTRACTORS

Foreword

Although the construction industry ranks as one of the largest in volume of business in the United States—construction contract awards totaled $32.2 billion in 1957—one finds few authoritative treatises on the application of generally accepted accounting principles to the construction industry. There are many articles and books by individual contractors and accountants which discuss record-keeping accounting systems and procedures (as opposed to principles) for contractors, and groups such as the American Society of Civil Engineers, for example, have published excellent manuals. The application of accounting principles in financial reporting, however, is obviously more significant than the mechanics of recording. Accordingly, it is the purpose of this booklet to interpret and summarize the application of generally accepted accounting principles as they particularly relate to the commercial business of contracting.

The committee wishes to acknowledge and express its appreciation for the assistance of William A. Blackmon, Jr., research consultant, in the research and preparation of this booklet.

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Introduction

Committee on Accounting Procedure

The American Institute of Certified Public Accountants has for many years made a concerted effort to narrow areas of difference in accounting practices. Beginning in 1939, the Institute's committee on accounting procedure has published many accounting research bulletins in order to attain this objective and to eliminate inconsistency in accounting practices.

Several of the bulletins of the committee on accounting procedure of the American Institute of Certified Public Accountants, such as Bulletin No. 45, "Long-term Construction-type Contracts," deal, almost solely, with contractors and the contracting business. One must look to other bulletins, however, for the Institute committee's opinions relative to the preferred and generally accepted accounting principles as they apply to accounting transactions peculiar to the contracting business.

This booklet represents an interpretation and commentary on the profession's position, and it seems appropriate, at the outset, therefore, to excerpt and quote several matters relating to this Institute committee's functions and publications.

> . . . the authority of opinions reached by the committee *rests upon their general acceptability*. The committee recognizes that in extraordinary cases fair presentation and justice to all parties at interest may receive exceptional treatment. But *the burden of justifying departure from accepted procedures . . . must be assumed by those who adopt another treatment*. The committee contemplates that its opinions will have application *only to items material and significant in the relative circumstances*. (Emphasis supplied.)

The members of the Institute, which include most practicing certified public accountants in the United States, do generally accept the opinions of the committee.

The committee on accounting procedure also has stated:

> Underlying all committee opinions is the fact that the *accounts of a*

> *company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements* and to state clearly such explanations, amplifications, disagreement, or disapproval as he deems appropriate. While opinions of the committee are addressed particularly to certified public accountants whose problem it is to decide what they may properly report, the *committee recommends similar application of the procedures . . . by those who prepare the accounts and financial statements.* (Emphasis supplied.)

In fulfilling his responsibilities as the auditor, the certified public accountant may not permit his name to be associated with statements purporting to show financial position or results of operations unless he shall: (1) express an *unqualified opinion,* or (2) express a *qualified opinion,* or (3) *disclaim an opinion* on the statements taken as a whole and indicate clearly his reasons therefor, or (4) when unaudited financial statements are presented on his stationery without his comments, *disclose prominently* on each page of the financial statements that *they were not audited.*

Basis for Recording Income

The principal problems and questions relating to accounting for construction contractors revolve around the recording of income on contracts. Such contracts may be of short or long duration and are basically of two types: fixed price and cost-plus.

The basis for recording income on contracts of short duration poses few problems. In the case of such contracts, profits are ordinarily recognized when the facilities are substantially completed and accepted. This accounting procedure has stood the test of time and should not be departed from except for cogent reasons.

The basis for recording income on construction-type contracts of long duration or term does pose special accounting problems because the work often extends over several accounting periods. The work is commonly financed to a considerable extent with advances from the contractor's client, and billings sometimes run ahead of the actual incurrence of costs by the contractor. The work of the contractor is usually performed "on the job" and the contractor has rights of lien rather than legal title. Thus the contractor's accumulated and incurred costs are more in the nature of receivables from his client than inventories.

Fixed-Price Contracts

The following are comments and interpretations of the Institute committee's accounting recommendations relative to long-term contracts wherein a contractor agrees to a fixed contract price which may result in either a gain or a loss on the completion of the contract. They apply to such long-term projects as the construction of a bridge, a large ship, a section of highway, an office building or apartment house, a dam or canal, a manufacturing plant, a sewer system, a subway, a large complex piece of equipment such as an electric generator, etc.

Selection of an Accounting Method

Two generally accepted methods of accounting are suggested by the Institute committee for long-term fixed-price contracts:

1. The percentage-of-completion method—"preferable *when estimates of costs to complete* and extent of progress toward completion of long-term contracts *are reasonably dependable.*"
2. The completed-contract method—"preferable *when lack of dependable estimates or inherent hazards cause forecasts* to be doubtful." (Emphasis supplied.)

The word "preferable" was used deliberately in the above recommendations to indicate that, while there is a presumption in favor of the "percentage-of-completion" method where reasonably dependable estimates can be made, there is similarly a presumption in favor of the "completed-contract" method when dependable estimates are lacking or inherent hazards cause forecasts and estimates to be doubtful.

It would be of course preferable in some circumstances to use one method for certain contracts and another for other contracts. It might appear that a contractor who employs such a combination of accounting methods is being inconsistent. This, however, is not the case. Consistency in application lies in according the same accounting treatment to the same set of conditions from one accounting period to another. The selection of a method should therefor be governed by a set of ground rules, consistently followed. For example, a shipbuilding concern might consistently use the "percentage-of-completion" method in accounting for the construction of new vessels which normally require approximately two years to build, whereas it would employ the "completed-contract" method for survey and other repair work which usually only requires a few days or months to complete.

It will be observed that the above quotation refers only to "estimates of costs." It is sometimes suggested that billings constitute a possible basis for the recognition of realized income on partially completed contracts. Such billings may, however, have no real relationship to performance under a contract. In some instances, knowingly or unknowingly, the contractor's client permits the earlier billings to be made in amounts which are excessive when compared with the work actually performed. This is a means of providing working capital for the contractor and the arrangement is referred to as an "unbalanced bid or contract." In other instances, to protect the owner, the "on account" billings may be purposely kept below the costs incurred, and thus below the amount due for the work performed. It is more common, however, to protect the owner by "retainage," which is usually 10 per cent of each billing, payable on completion of the contract. It will be observed from the above comments that *generally billings are not a suitable basis for income or profit allocation.* By using costs of comparable work previously performed a contractor may be able to arrange billings under a new contract in such a manner that an appropriate income allocation will result. This situation is obviously not one of mere chance, but in itself does not repudiate the fact that billings may have no real relationship to performance, whereas costs ordinarily do.

It is sometimes suggested, say in relation to a particular long-term contract or to a contractor having numerous long-term contracts, that the selection of the accounting method will give a totally different picture of the financial position and results of operations. However, a close reading of the bulletin comments on the selection of an accounting method indicates that the two methods are mutually exclusive for one specific contract. It is only with the benefit of hindsight that one can say following completion of a five-year contract, "had it been recorded on the 'percentage-of-completion' method instead of the 'completed-contract' method the profit at the end of the first year would have been $10,000 instead of zero."

Percentage-of-Completion Method

The generally preferred method for recording income on long-term contracts is the "percentage-of-completion" method, which recognizes income on work as a contract progresses. This method has the advantage of periodically recognizing income on a current basis rather than irregularly as contracts are completed. It also reflects the status of incompleted contracts. The major disadvantages of this method is its necessary dependence on estimates of ultimate costs which are subject to uncertainties.

The Institute's committee on accounting procedure recommends that income to be recognized in a contractor's accounts be either:

> (a) that percentage of estimated total income that *incurred costs* to date *bear to estimated total costs* after giving effect to estimates of costs to complete *based upon most recent information, or*
>
> (b) that percentage of estimated total income that may be indicated by *such other measure of progress* toward completion as may be appropriate *having due regard to work performed.* (Emphasis supplied.)

In applying the first of the above methods the bulletin recognizes that, since work performed is the primary basis for income allocation, certain costs may be disregarded as a measure of performance in the early stages of a contract for the purposes of determining income allocation. The bulletin qualifies the statement relative to "incurred costs to date" by saying as follows:

> *Costs* as here used *might exclude*, especially *during the early stages* of a contract, *all or a portion* of the cost *of such items as materials and subcontracts* if it appears that *such an exclusion would result in a more meaningful* periodic *allocation of income.* (Emphasis supplied.)

The above qualification takes into account situations in which substantial quantities of materials may have been accumulated on a job site but not used, or situations in which engineering or architectural fees have been incurred, which may, for example, represent 15 per cent of total estimated costs when, in terms of work performance the contract was only 5 per cent completed. In these circumstances income recognized as allocable to the period should be related fully to only 5 per cent of the total, and not to the extent of 15 per cent.

Under the second alternative above, "such other measure of progress" is intended to recognize the possibility of using other factors as measures of percentage-of-completion where they, more appropriately than costs incurred to date, measure work performed. Such measures may be, for example, cubic yards of excavation for foundation contractors; or cubic yards of cement or asphalt laid for highway contractors; or engineering or architectural estimates of percentage of completion. Where a more meaningful allocation of income would result, it is, of course, permissible and even more appropriate for one contractor to use different methods of estimating work performed on several different types of contracts.

Completed-Contract Method

The second of the two generally accepted methods, the "completed-contract" method, recognizes income only when a contract is completed, or substantially so. During the period of construction, billings and costs are accumulated, but no profits or income are recorded before the substantial completion of the work. A contract may be regarded as substantially completed if *remaining costs are not significant in amount.*

This method's principal advantage is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforseen costs and possible losses. Its disadvantage, of course, is that it does not reflect current performance when the period of a contract extends through more than one accounting period. Under the latter circumstances, the method may result in an irregular recognition of income, and in some situations (for example, single proprietorships or partnerships) it may, through an irregular recognition of taxable income, subject the individuals concerned to greater income tax liabilities.

It is to be observed that Bulletin No. 45, in referring to the "completed-contract" method, states income is to be recognized when a "contract is completed, *or substantially so.*" The latter words, defined and explained above ("A contract . . . is substantially completed if remaining costs are not significant in amount") had twofold significance to the Institute committee. First, seriously misleading results could occur as for example if a contractor was not permitted to recognize income under this method at (say) his December year-end and was forced to defer the recording until January, or, worse still, until months later when the project was declared legally completed in accordance with local ordinances and codes. Secondly, the committee properly desired to discourage a deliberate postponement of the recording of income on a contract by deferring the performance of some minor part of the work.

It is common practice not to accumulate as contract costs general and administrative expenses and similar general expenditures sometimes described as overhead or indirect expenses. Such expenses are usually treated as "period costs" (i.e., current expenses). Under the "percentage-of-completion" method, such difficulty is rarely encountered because there is periodic recognition of income from which such items can be deducted. However, this may not be the case when the "completed-contract" method is employed. The Institute committee therefore stated:

> When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather

than periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed.

The words "may be appropriate" are used deliberately since a contractor who employs the "completed-contract" method may be engaged in numerous projects and it may be preferable for him to charge those expenses to periodic income as they are incurred as no material distortion of net income would occur. However, if there is only one contract (or just a few contracts), and no income (or an abnormally small amount of income) is recordable on the completion of contracts in a specific period, seriously misleading results might be shown if general and administrative expenses were expensed as incurred in each accounting period. The election by the contractor to allocate general and administrative expenses to contract costs, like the selection of one of the two methods of accounting for contracts, should be governed by a set of ground rules, consistently followed.

The bulletin cautions its interpreter as follows:

In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

Here the committee apparently had in mind that, when construction volume was at a low point, only a reasonably allocable or normal amount of overhead costs should be assigned to contracts in process. The remaining general and administrative or overhead costs should then be shown as period expenses even though net losses were thereby produced.

Provisions for Foreseeable Losses and Renegotiation Refunds

In accordance with the long-established accounting practice of anticipating losses (but not gains), Bulletin No. 45 recommends that when current estimates of total contract costs indicate a loss, provision should be made for the entire loss on the contract. This recommendation applies to both the "percentage-of-completion" method and the "completed-contract" method, even though the latter does not permit the recording of income prior to completion. However, as to both methods, the bulletin also states:

If there is a close relationship between profitable and nonprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

This qualification is added so that when several contracts are parts of the same over-all project, they will be treated as a unit in estimating profits or losses. If this were not done, revenues and costs relating to the same project might be recorded in different accounting periods.

Ordinarily, a provision for loss on a contract should not be necessary unless the total estimated direct contract costs are expected to exceed the total contract price and then only to the extent such costs exceed the contract price unless general and administrative expenses, or a portion thereof, have been allocated to the contract costs under the "completed-contract" method. In the latter case in determining the need for a provision for loss, the total general and administrative expenses that it is estimated will be incurred and allocated by the time of completion of the contract should be considered together with the estimated direct contract costs.

In computing the need for provisions for losses on contracts, penalty liabilities for indicated late completion should be included in total estimated costs. When the contractor is working on a "cost-plus" basis, unreimbursable costs—be they unauthorized in themselves or amounts in excess of those authorized or in excess of "guaranteed maximum costs"—should be considered in determining whether the contract is a profitable or unprofitable one. Under some circumstances consideration will need to be given to such other factors as escalation, change order extras, price redetermination, etc. On the other hand, incentive bonus provisions for early completion or for low costs should also be taken into account in determining the gain or loss status under contracts.

With the accrual basis of accounting, recognition is given to revenues, costs, and expenses, to the fullest extent possible in the periods to which they relate. As previously indicated, it is also, with the "percentage-of-completion method," a generally accepted accounting procedure to accrue revenues under certain types of contracts on the basis of partial performance if the circumstances are such that total costs and profits can be estimated with reasonable accuracy and ultimate realization is reasonably assured. With these principles and procedures in mind, the question is sometimes raised: Why not recognize the loss over the period of the contract? Assuming the exception commented on later under this section is not applicable, it must be said that the accounting dogma of anticipating losses when they are reasonably determinable becomes dominant over the two aforementioned principles. In brief, the entire loss accrues at the time when the current estimates of total contract costs indicate a loss because such estimates indicate that the loss will not be recoverable from future revenues on a contract or group of contracts relating to the same project. Such being the case, there is no merit in postponing the recording of portions of a loss to the future. The Institute committee has taken a parallel position on the recognition of losses in bulletins dealing with such matters as inventory losses, losses on purchase and sale commitments, and unrealized losses on foreign exchange.

Under some circumstances, government contracts and subcontracts are subject to renegotiation—that is, an adjustment of the original contract price with a refund payable to the government. Provisions for renegotiation refunds are similar to other provisions for foreseeable losses on contracts to the extent that when such probable refunds can be reasonably estimated, liability therefor should be recognized in the financial statements. The amount of refund recognized by the provisions should not, however, exceed that applicable to billings recognized as income to that date. Provision for such refunds should be included in the statement of financial position among current assets or liabilities in accordance with the principles outlined in the section "Working Capital." When such refunds cannot be estimated, it should be disclosed that the contractor is unable to determine renegotiation effects, and that there are consequent uncertainties in the financial statements. Renegotiation provisions differ from other loss provisions in that they do not normally produce a contract loss but a reduction in previously anticipated profits. Renegotiation refunds involve only a refund of "excessive profits." The accounting treatment of such refunds in the income statement also differs from other loss provisions which are shown as contract costs. Provisions for renegotiation should preferably be treated in the income statement as a deduction from contract revenues.

This query has been made: If the "completed-contract" method (rather than the "percentage-of-completion" method) is selected as a result of a lack of dependable estimates of costs, are not the estimates equally unreliable for purposes of estimating an allowance for loss on a contract? The provision for a loss should represent, under either method, the best judgment that can be made in the circumstances. If "inherent hazards" are not present, it must be presumed that the "completed-contract" method is selected because there is no dependable estimate of costs. However, the selection and application of this method in accounting for the normal business operations of a contractor does not of itself preclude the fact that a loss will become clearly apparent at some stage of completion. The bulletin therefore uses the words "expected" loss to indicate that the actual realization of the loss should be reasonably certain. To "expect" or to be reasonably certain that a loss will occur, a contractor must be presumed also to be in a position to approximate reasonably the amount of such a loss. The "long-established accounting practice of anticipating losses" referred to above, does not recommend arbitrary provisions for losses, but presumes the exercise of care and good judgment.

When provisions for estimated losses on uncompleted contracts are made on the books and in the financial statements, and such provisions are not currently deductible for income tax purposes, it would be proper to make such provisions "net of taxes." That is to recognize (at the estimated effective tax rate) the future tax reduction at the time or times that the loss is deductible. If this were not done, the contractor's income would be improperly reduced in one accounting period by, say, an amount equivalent to half the total provision for loss and the income would be improperly increased in the subsequent accounting period, or periods, by the tax effect of the deduction of the loss in that period or periods. By providing for the loss "net of taxes," the estimated net loss (i.e., after taxes) is properly reported in the accounting period in which the loss is foreseen.

Loss provisions "net of taxes" presuppose that there is other taxable income or "carryback" privileges then available at least to the extent of the deductible contract loss. Were this not so the contract loss would produce no reduction in income taxes and should not then be recorded "net of taxes." It would not be proper accounting to anticipate future taxable income and, assuming a "carry forward loss," provide for contract losses "net of taxes."

In computing the tax effect, the estimated rate should be based on rates in force during the period covered by the income statement with such changes as can be reasonably anticipated at the time the estimate is made. It is, of course, appropriate to consider the tax effect as the difference between the tax payable with and without including the loss as a reduction of taxable income. All significant income taxes, U. S. Federal, foreign, state and local, should be considered in the computation, and reasonable approximations in round figures will suffice.

Cost-plus Contracts

Cost-plus contracts are commonly entered into by contractors. As earlier indicated they are employed in a variety of forms such as cost plus a percentage of cost, or cost plus a fixed fee. In the latter circumstance, defined costs may be limited and penalties made payable under guarantees, such as guaranteed maximum costs (or billings). When there are penalties, it is usual to provide as well for incentive or bonus payments.

Under "cost-plus" agreements, contractors usually are reimbursed at intervals for their expenditures and, in addition, are paid a specified fee. Payments on account of the fees (less "retainage," 10 per cent or another amount which is withheld until completion) are made from time to time as specified in the agreements, usually subject to the approval of the client's employees or an agent, such as the architect. In most cases the amount of each payment is, as a practical matter, determined by the ratio of costs incurred to total estimated costs. "Cost-plus" agreements often provide that ownership of all material vests in the client as soon as the contractor is reimbursed for his expenditures or, in some instances, immediately on receipt of the material by the contractor even though not yet paid for. In such instances, the contractor has a custodianship responsibility for these materials. Frequently the client makes cash advances to provide working funds to the contractor and often such sums are applied against the final payment due under the contract.

The selection of a generally accepted accounting method for recognizing income under "cost-plus" type contracts generally parallels that mentioned for "fixed-price" contracts. It is thus generally accepted procedure to accrue revenues and thereby recognize profits on the basis of partial performance when total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. It is acceptable to accrue fees as they become billable. When estimates are unreliable the "completed-contract" method is preferred to the "percentage-of-completion" method, as with "fixed-price" contracts.

Provisions for foreseeable losses, including penalties, guarantees, etc., should also be made at the time the loss is indicated. Comments relative to such provisions have already been made—see subsection "Provisions for Foreseeable Losses, etc."

One problem peculiar to "cost-plus" contracts is: What amounts should be included in revenue accounts—the reimbursable costs and the fee, or the fee alone? Some contracts are of a service nature under which the contractor acts solely in the capacity of an agent. Such contracts appear to call for inclusion of the "fee" alone in the income statement and, of course, the contractor would not show materials purchased and owned by his client among his own assets. In other situations the contractor's position is in many respects that of an ordinary principal.

For example, he is responsible to employees for salaries and wages, and to subcontractors and other creditors for materials and services, and the contractor often uses his own facilities in performing his responsibilities under the agreement. In such situations it is proper to include reimbursable costs as well as fees in the income statement. In summary, then, judgment must be exercised as to which method provides more useful information. The terms of each particular agreement, naturally influence the decisions.

Terminated Government and Other Contracts

For the convenience of the government, contracts may be terminated to adjust production for the military services or contractor's clients may terminate their contracts for various business reasons. Thus, termination has the effect of converting an active contract in process of execution into a claim in process of liquidation, or, from an accounting standpoint into an account or claim receivable. Under ordinary circumstances, a termination claim should be classified as a current asset. Under either a fixed-price or cost-plus contract, any remaining profit accrues as of the effective date of termination, not at the date of final settlement or some intermediate date. It will be observed that, from the viewpoint of timing, this accounting parallels recognition of foreseeable losses. The profits to be accrued should of course be estimable and realization thereof reasonably assured. Full disclosure should be made by footnote if determinate elements or items of known controversial nature exist and estimates are not practicable. While the total claim, and particularly the profit allowance, is subject to negotiation, termination articles provide for a formula settlement allowing definite percentages of profit based on costs in the event of the failure of negotiations. Such articles thus fix a minimum profit allowance. Under most circumstances, a contractor may accrue the minimum profit allowance determined by the formula when he is otherwise unable to determine a more appropriate profit allowance.

Items retained by the contractor as scrap or for his own use or for resale to outsiders, should be properly valued and deducted from the contractor's termination receivable. Such retentions in some instances may be of such significance that a contractor may make a so-called "no-cost" settlement, in which case no termination claim is made and no profit accrues until the future disposition of the retained items.

The primary basis for properly valuing items retained by a contractor is cost. In principle, cost means the sum of expenditures directly or indirectly incurred in bringing an article to its existing condition and location. A departure from this basis of pricing is required, however, when the utility of the goods is no longer as great as its cost. Often this may be the case to a contractor on the occasion of a termination when some items may cease to have any utility value other than as scrap. The recognition of a lowering in the utility of goods is generally accomplished by stating them at a lower level commonly designated as "market." The accounting rule "cost or market whichever is lower" provides therefore a means for measuring the residual usefulness of an inventory expenditure. The term "market" means current replacement cost, by purchase or reproduction. In applying these rules, judgment must be exercised and losses should not be recognized unless there is clear evidence that a loss has been sustained. For example, replacement or reproduction prices would not be appropriate when the estimated sales value, reduced by costs of completion and disposal, is lower. Furthermore, where the evidence indicates that cost will be recovered with an approximate normal profit on sale, no loss should be recognized even though replacement or reproduction costs are lower.

The claims of subcontractors can pose problems in the event of a contract termination. Frequently the contractor has no control over the filing of subcontractors' claims and may not know their amount until some time after the termination date. If the amounts of claims of subcontractors are not reasonably determinable, this should be disclosed by footnote in the contractor's financial statements.

There is also the possibility that the contractor may suffer loss through his failure to recover the full amount of his liability on subcontractors' claims. Foreseeable losses of this character should be provided for just as other contract losses are provided for.

The Institute committee on accounting procedure considered either of two alternative methods of presenting subcontractors' claims acceptable in the financial statements of a contractor since both methods meet the test of adequate disclosure. On the one hand, recoverable subcontractors' claims may be considered to be in the nature of contingent liabilities with an offsetting contingent asset in the form of the termination claim. These offsetting amounts may, as no loss is expected, be omitted from the contractor's financial statements and their existence disclosed by footnote. As another alternative, subcontractors' claims may be recorded in the contractor's statement of financial position as current liabilities and the amounts recoverable by the contractor may be included in his termination claim receivable in such statements.

Working Capital

In August 1947, at the time of issue of Accounting Research Bulletin No. 30 on "Working Capital" (now restated as Chapter 3 of Bulletin No. 43), the Institute committee observed: (1) that considerable variation and inconsistency existed with respect to the classification and display of current assets and liabilities in financial statements; (2) that previous definitions of current assets has tended to be overly concerned with whether such assets were immediately realizable; and (3) that creditors and others tended to rely more on the ability of debtors to pay obligations out of proceeds from current operations and less on the debtor's ability to pay in an instance of liquidation.

Financial statements of contractors (and others) are prepared on the "going concern" basis, namely on the assumption that a company will continue in business. Usually, the certified public accountant's opinion is based on the same assumption. With this in mind the Institute committee on accounting procedure departed from a narrow definition or strict one-year interpretation of either current assets or liabilities and related the criteria of determining current assets or liabilities to the operating cycle of the business involved.

The committee described its concept of the operating cycle as follows:

> The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, . . . labor, and . . . services, and such expenditures are accumulated as . . . costs. These costs . . . are converted into . . . receivables and ultimately into cash again. *The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an operating cycle.* A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year. *However, where the period of the operating cycle is more than twelve months, as in, for instances, the tobacco, distillery, and lumber businesses, the longer period should be used.* Where a particular business has no clearly defined operating cycle, the one-year rule should govern. The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. (Emphasis supplied.)

With the above concept still in mind the Institute issued, in late 1955, Bulletin No. 45. In this bulletin, in discussing both the "percentage-of-completion" and the "completed-contract" methods, they suggested that amounts of costs, billings and income be included in either current assets or current liabilities. (The full statement of the committee is reproduced later in this booklet under the subhead "Offsetting or Netting Amounts.")

Illustration: A moderate-sized plumbing contractor normally engaged in residential construction and repair work (for which the contracts are usually of only several months duration) would normally, since "there are several operating cycles occurring within a year," classify his costs and billings as current assets and liabilities under the one-year rule. However, if he were functioning as a subcontractor for a large housing development, which might take several years to complete the retainage would properly be excludable from the current assets of the plumbing contractor until its collection could be expected within a one-year period. In contrast, the liability to the subcontractor for the retainage would be properly classifiable by the general contractor as a current liability if that contractor had a normal business cycle of several years duration.

Observance of the philosophy or concept of this bulletin will be seen in the published financial statements of large contractors employed on such long-term projects as shipbuilding or electric generating station construction. Because such contracts have a normal long-term business cycle, their costs and billings are properly classifiable as current assets or current liabilities.

Judgment must be exercised to determine, based on the nature of the business of the contractor, what the period of his normal operating cycle is. Where the contractor tends to specialize in a certain type of project his normal business cycle is likely to be clearly defined. On the other hand, where his business is diverse and the period for completion varies markedly, it would appear that the longest period representing a substantial portion of the business would represent the normal operating cycle and all contracts with lesser periods would also fall within the working capital classification.

Questions are sometimes raised about such items as the cash surrender value of life insurance. Why isn't it normally shown as a current asset? Such insurance is not purchased by a company with the idea of cashing it in when the company requires working capital, and it may therefore be considered comparable to any other noncurrent asset which a company has no intention of selling, but which may be pledged as collateral for a loan. The term current assets then is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash, or sold, or consumed during the normal operating cycle of a business. When there are reasonable doubts as to the collectibility of any items in the ordinary operating cycle of a business, such items should be excluded from the current asset category.

Occasionally, the question also arises as to whether a contractor's investment in a joint venture is a current asset. Generally speaking (as each situation should be judged on the facts of its circumstances), such an investment would be classifiable as a current asset if and to the extent that the underlying assets of the venture were classed as current in the statements applicable to the venture. If the operating cycle of the venture does not parallel that of the contractor investor that fact should be disclosed.

Sometimes it is argued that, under the "completed-contract" method, the excess of billings over related costs should not be shown as a current liability because, at least in part it represents income to the contractor, but should be shown as "deferred income." The committee suggested, in recommending the selection of a method, that the "completed-contract" method was preferable only when dependable estimates of total costs were lacking or when inherent hazards caused forecasts of total costs to be doubtful. When a contractor has adopted the "completed-contract" method because of a lack of dependable estimates or inherent hazards, he can hardly argue in advance of substantial completion of a contract that "X dollars" represents profit earned to date or deferred income. In discussing the "completed-contract" method earlier in this booklet, it has been noted that income should be recognized on substantial completion of a contract. In such circumstances obviously the recording of deferred income in the balance sheet would be improper. It must be recognized also that while a project is in process, a portion or all of the excess of billings over related costs may represent advance payments by the contractor's client. The most practical and conservative solution, therefore, is to treat such items as liabilities, in most cases as current liabilities, until the income on the contract has been proved to be realized by substantial completion thereof.

Contractor's Equipment

Contractors either own or rent heavy equipment such as trucks, graders, cement mixers, scrapers, cranes, power shovels, derricks, air compressors, rock drills, pumps, etc.

When heavy equipment is rented, the accounting is comparatively simple. The cost of such equipment is allocated to the particular jobs where it is used on some reasonable basis such as time, mileage, etc. Substantial rental commitments should be disclosed in footnotes to a contractor's financial statements. When rented equipment is owned by an affiliate the rental costs should be separately disclosed and identified. Intercompany profits from such rentals should, of course, be eliminated in the preparation of consolidated financial statements.

Vendors of contracting equipment sometimes lease their equipment to contractors with an option to purchase at a later date. Such arrangements must be clearly distinguishable from a conditional or outright sale of the equipment. Purchase option rentals offer the advantages of immediate rental deductions for tax purposes (which can be larger than depreciation allowances), smaller immediate outlay of funds, and an opportunity to evaluate the equipment under operating conditions. Rental amounts paid by the contractor lessee should be recorded as jobs costs or expenses. The net amount paid (that is gross price for the equipment less rentals allowed against that price) should, on exercise of the purchase option, be capitalized and depreciated over the remaining useful life of the equipment.

Under some circumstances a lease arrangement may represent no more than an installment purchase of the equipment. This may be the case in the following circumstances:

1. When the lease is made subject to the purchase of the equipment for a nominal sum or for an amount obviously much less than its fair value at the time of purchase.
2. When the lease agreement stipulates that the rentals may be applied in part as installments on the purchase price of the equipment.
3. When the rentals obviously are not comparable with other rentals for similar equipment so as to create the presumption that portions of such rentals are partial payments under a purchase plan.

In the above circumstances, it should not be assumed necessarily that just because the lessee does not have legal title to the property and does not assume any direct mortgage obligation that it would be improper to include the equipment among the contractor's assets and to show the related indebtedness as a liability. The underlying facts relating to all leases such as the above should be very carefully considered and where it is clearly evident that the transaction is in substance a purchase, the leased equipment should be included among the assets of the contractor-lessee with suitable accounting for the corresponding liability and for the related depreciation and interest charges in the contractor's income statement.

Owned fixed assets of contractors are usually recorded at cost and classified into three general categories: (1) heavy machinery and equipment, (2) miscellaneous tools and equipment, and (3) trucks and autos. When the operating costs of equipment are substantial in amount, it is essential for the contractor to maintain an equipment operating cost ledger. This record not only supplies information as to the location of the equipment but more importantly serves as a basis for allocation of costs to specific jobs and by comparisons between similar equipment provides information as to relative efficiency and economy of the equipment. Most contractors establish a unit cost of operation for pieces of equipment and charge the jobs at these rates. Operating and maintenance costs of miscellaneous small tools and equipment are usually charged to overhead accounts rather than specific jobs. However a contractor may allocate such costs directly to specific jobs where the costs relate to such jobs.

In establishing operating unit costs for equipment, it is appropriate for contractors to apply rates arrived at under the so-called "use rate" theory. In applying this theory, the following factors must be considered: (1) the cost of the equipment, less estimates of its salvage value, or its rental cost if it is not owned equipment, (2) the probable life of the equipment, (3) the average idle time during the life or period of hire of the equipment, and (4) the costs of operating the equipment—such as repairs, storage, insurance, taxes, etc. From these factors, rates per hour, day or week, etc., may be arrived at, which, based on the reported use of the equipment, will serve as a basis for charging the jobs on which the equipment is being used. Since the early 1920's, the Associated General Contractors of America have made frequent studies of the operating costs of various types of equipment on construction work and they have issued schedules of rates.

The word *depreciation* is an outstanding example of a term which has a specialized meaning in its accounting senses, and has other meanings to engineers and economists as well as in common English usage. The Institute committee on terminology recognized the obligation of the accounting profession to clarify the meaning of this word as used in the art of accounting. After long consideration this committee formulated the following definition and comments which were issued as Bulletin No. 20 in November 1943 (later reconfirmed and reissued in August 1953 together with other definitions as Terminology Bulletin No. 1):

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

Reference to and careful consideration of the above definition will help resolve depreciation problems in connection with contractor's equipment. Often contractors purchase equipment for a specific job, and on completion of that job, dispose of the equipment, rather than retain it for future work. In these circumstances the useful life of the equipment to the contractor, and therefore the accounting period for depreciation allocation is the term of the job—say two years—and not the physical life of the equipment which may be ten years. The amount to be depreciated should be its total cost less its estimated salvage value at time of disposal.

A number of methods for allocating depreciation have come into use over the years, the most common of which is the so-called straight-line method under which the cost, less salvage value, is equally allocated over the estimated useful life of the equipment. Although such methods as the "declining-balance" and "sum-of-the-years' digits" had a long history of prior use in England and other countries, their specific recognition for income tax purposes in the United States suggested their particular consideration by the accounting profession in this country. The Institute committee on accounting procedure in October 1954 as Bulletin No. 44 (superseded by a revised Bulletin No. 44 in July 1958) stated that such methods met the defined requirements of being "systematic and rational," and then concluded as follows:

> In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance (or sum-of-the-years' digits) method may well provide the most satisfactory allocation of cost.

The revised bulletin recommends that when either of these accelerated methods is used for income tax purposes but not for financial accounting and the amounts are material, that accounting recognition should be given to deferred (i.e., postponed) income taxes. The further suggestion is made that the tax deferred amounts should not be recognized as a liability but rather as additional amortization or depreciation applicable (and deductible) to such assets where it is reasonably presumed that the accumulative difference between financial and taxable income will continue for a long or indefinite period.

It may be desirable in some circumstances to supplement a contractor's financial statements with a footnote explaining the depreciation policies observed.

One can hardly refer to the general subjects of equipment costs and depreciation accounting without mentioning the accounting profession's point of view toward inflation and its impact on capital assets. Certainly the general effects of inflation on construction costs in recent years have made this subject a day-to-day problem in the contracting business.

Observing that this matter is one of continuing importance, the Institute committee has formally considered the subject on three occasions in recent years—December 1947, October 1948 and June 1953. The committee concluded on each of these occasions that no basic change in the accounting treatment of depreciation of plant and equipment was practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar. The committee did however support the use, where appropriate, of supplementary financial schedules, explanations or footnotes as a means of informing stockholders, employees and the general public of a business need to retain, out of profits, amounts sufficient to replace productive facilities at current prices if it were to stay in business.

Form and Content of Financial Statements

Comparative Statements

The presentation of comparative financial statements in annual and other reports emphasizes that statements for a series of periods are more significant than for one period and, thereby, enhance the usefulness of such reports by bringing out more clearly the nature and trends of current changes affecting the contractor. It is, of course, necessary that prior-year amounts—which are shown for comparative purposes—be, in fact, comparable with those for the most recent period, or that any exceptions to comparability or changes which have occurred in the manner of, or basis for, presenting corresponding items be disclosed and explained. When it is appropriate, such prior-year amounts should be expressed in a manner that affords some means of comparison.

Many segments of the business of contracting are unusually hazardous and do not have the element common to most manufacturing enterprises of similar production. When the contractor's services change in nature or size, the comparability of the financial statements may be less significant. In such circumstances, it is more important to disclose and thereby distinguish changes in the business by separately labeling items in the financial statements, thus drawing them to the attention of the reader.

Cash Basis vs. Accrual Basis Accounting

Although the cash basis for recording financial transactions is acceptable for some reportings, it is not acceptable for financial statements which purport to present financial position or results of operations when the cash basis accounting practices produce results which are materially at variance with those customarily followed in preparing accrual basis statements. Ordinarily the accrual basis is the only generally accepted basis for contractors' financial statements. When, however, contractors' statements are prepared entirely or substantially on a cash basis, this fact should be disclosed in the statements or in their footnotes. The statements or footnotes thereto should also indicate clearly the general nature of any material items omitted (such as accounts receivable and payable) and the net effect of such omissions on the statements. Similar standards of disclosure should apply to such statements when prepared on a modified accrual basis.

Offsetting or Netting Amounts

It is a basic general principle of accounting that the offsetting of assets and liabilities in statements of financial position (or balance sheets) is improper except where a right of set-off exists. Thus the net debit balances for certain contracts should not ordinarily be offset against net credit balances relating to others, unless the offsetting balances relate to the same client of the contractor. A strict legalistic interpretation of the words, "the same client," is not intended here. Thus, where there is a close relationship, as in the case of contracts which are parts of the same project, the group may be treated as a unit in offsetting net debit and credit balances for statement presentation purposes.

The Institute's committee on accounting procedure recognized the basic accounting principle of offsetting as described above when it dealt with the two accepted methods of accounting for long-term construction-type contracts. Thus, in discussing the "percentage-of-completion" method, the bulletin states:

> . . . current assets may include costs and recognized income not yet billed, with respect to certain contracts; and liabilities, in most cases current liabilities, may include billings in excess of costs and recognized income with respect to other contracts.

And, in commenting on the "completed-contract" method, the bulletin states:

> . . . an excess of accumulated costs over related billings should be shown in the balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilities, in most cases as a current liability.

Reaffirmation of the theory of offset is to be found in the further statement by the committee relative to the "completed-contract" method as follows:

> If the costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs.

The Institute committee undoubtedly considered the theory of offset to be equally applicable to the "percentage-of-completion" method, but probably did not specifically use language paralleling that which is quoted above relative to the "completed-contract" method, as such a statement would be redundant.

The above quotations from Accounting Research Bulletin No. 45 do not indicate, through the suggested mechanics of segregating contracts that are classifiable as current assets from those that are current liabilities, whether billings and related costs should be presented separately or combined (or netted). As separate disclosure in comparative statements can be informative of the status of dollar volume of billings and costs (but not an indication of future profit or loss thereon), this reporting practice is believed to be preferable. In addition, grantors of credit, such as banks and insurance companies have expressed preference for separate disclosure. This may be accomplished through "short extension" of the amounts on the statement of financial position or disclosure in the notes to the financial statements. Thus, under the "percentage-of-completion" method, the current assets may disclose separately total costs and total recognized income not yet billed with respect to certain contracts; and current liabilities may disclose separately total billings and total costs and recognized income with respect to other contracts. The separate disclosure of revenue and costs in statements of income is, of course, generally accepted. Only through comparable presentation of such data in the statement of financial position can the reader adequately evaluate the contractor's comparative position.

An advance received on a "cost-plus" contract is usually not offset unless it is definitely regarded as a payment on account of work-in-progress, in which event it will be shown as a deduction from the related asset. Advance amounts offset should, of course, be disclosed. Such advances generally are made for the purpose of providing a revolving fund and are not usually applied as a partial payment until the contract is nearly or fully completed. However, when a terminated government contract is one on which advance payments had previously been received, the financial statements of the contractor issued before collection of the claim should ordinarily reflect any balance of those advances disclosed as deductions from the claim receivable.

The Institute committee recommends that provision be made for the loss on a contract when current estimates indicate expected losses. (Commented on earlier under the subheading "Provision for Foreseeable Losses, etc.".) The total provision for such losses, which might be termed "estimated loss on uncompleted contracts," should be disclosed in the statement of financial position or notes thereto and not "netted" without disclosure. Such allowances should be shown in total as reductions of those contract costs includable in current assets or additions to those includable in current liabilities. An allowance for loss may, of course, change a contract which would otherwise be includable in current assets to one includable in current liabilities, since it represents costs for which the contractor will not be reimbursed.

Disclosure of Accounting Basis for Recording Income

The selection of a method of accounting for income by contractors has been commented on, and it was observed that it may be appropriate in some circumstances to select and use both accepted methods. Specific disclosure of the method which is used should be made either in a footnote or in the terminology employed in the financial statements. An indication such as "accrual basis" is not sufficient disclosure as both the "percentage-of-completion" and "completed-contract" methods use accrual basis accounting. Disclosure of the use of the "completed-contract" method is sufficiently self-explanatory. However, a statement that the "percentage-of-completion" method has been used without an indication of how this method is employed would not seem to be a sufficient disclosure as in practice this method is applied in a variety of ways, some of which tend to be less reliable than others. When the "percentage-of-completion" method is used, then the financial statements should include a note. Example:

> The company records profits or losses on its long-term contracts through estimates on the percentage-of-completion basis. The basis on which such profits or losses are recorded prior to completion is, when progress thereon reaches a point where experience is believed to be sufficient to establish estimates reasonably indicative of final results (such point is in no case less than 25 per cent of completion), to accrue as an estimated ultimate loss, the full amount thereof, and as to an estimated profit, that portion which is deemed allocable, on the basis of engineers' estimates of the percentage-of-completion, to expenditures incurred and work performed. Income from short-term contracts is recorded on substantial completion of each contract.

The most acceptable methods for recording income are likely to differ under the two basic types of contracts (namely, cost-plus, in its variety of forms, such as "cost-plus percentage of cost," "cost-plus fixed fee," these with or without "guaranteed maximum billings"—and fixed price or "lump sum"). Therefore, it is usually desirable not only to segregate total amounts relating to each type of contract in the financial statements, but to indicate the methods adopted for recording income thereon.

Supplemental Financial Information and Other Desirable Disclosures

Mention has been made of the desirability of disclosing the following matters in the financial statements of a contractor:

> Existence of renegotiation refunds, termination claims and claims of subcontractors; the nature of changes in a contractor's business; utilization of cash, rather than accrual, basis of accounting; amounts provided for contract losses; method of income realization, supplemental information on joint venture operations; amounts of intercompany transactions; amounts of rental commitments; depreciation policies; etc.

Disclosure should also be made of such additional matters as unusual labor agreements; material purchase or sale commitments; hypothecated assets; loan agreement restrictions; and penalty or guarantee provisions of construction contracts. In addition to the required disclosures mentioned above, it is most informative to supplement a contractor's regular financial statements with information of a statistical nature on movement of contracts. Such information can take the form of indicating the total amount of contracts in progress at the beginning of the year, new contracts entered into during the year, contracts completed during the year and total amount of contracts in progress at the end of the year. It is helpful to have this information in a comparative form. It is also desirable, in some instances to disclose the constituent parts of such information; for example, to show different classes of projects on which the contractor is engaged, or separate listings of domestic and foreign operations, etc. It should be noted that supplementary information of this nature is very much desired by credit grantors.

Forms issued by grantors of credit, including surety companies, and many state road and highway departments often require further details of certain financial information. Observance of the accounting principles herein reviewed and the suggested form and content of a contractor's financial statements should result in a fair presentation of his position and results of operations. However, the contractor and his accountant should acquaint themselves with the requirements called for by the forms above mentioned and be prepared to supply the necessary supporting details.

Joint Ventures

As a means of spreading risks and pooling financial resources and skills for certain jobs, it is common for contractors to join forces through the use of a joint venture, a form of partnership. The members of the joint venture may be either sole proprietorships, partnerships, or corporations, but the joint venture itself is a separate business entity for which separate accounts are usually kept. Each member of the joint venture usually contributes capital and may have accounts receivable from the joint venture for equipment rentals, engineering, architectural or other services, sales of material and other items. It is also common for the participants to bill the joint venture for interest on capital invested, accounting and other overhead expenses incurred on behalf of the joint venture. The methods for reimbursing and compensating the participants are usually provided for in the joint venture agreement.

The investment of a contractor member in a joint venture as well as receivables from the joint venture should be separately disclosed in his financial statements if these items are material in amount. It is sometimes possible to separate the investment in a joint venture and receivables therefrom into current and noncurrent portions based upon the underlying assets of the joint venture (see comments in section "Working Capital"). The contractor's share of joint venture earnings should be shown separately in the income statement of the contractor. It is not common to record the proportionate share of billings and costs applicable to joint venture operations in the financial statements of individual members.

The joint venture should make its own election as to the method of recording income on its construction contracts, and this method can differ from the methods used by members of the joint venture in their financial statements. The approach to the selection of a method for recording income of a joint venture should be the same as that for recording income under contracts (see subheading "Selection of an Accounting Method"). Each member of the joint venture may record his share in the income or losses of the joint venture for the fiscal year of the joint venture ending in the fiscal year of the member. However, members may elect to record income or losses of the joint venture as reports on joint venture operations are received.

If the venture income or investment is financially significant with respect to the contractor's own operations, it is preferable to include the separate financial statements of the venture with the financial statements of the contractor. The venture financial statements should, of course, disclose the method of recording income and the other matters referred to in the preceding subsection. If separate financial statements are not provided, it is generally advisable to set forth in a footnote to the contractor's financial statements a summary of the assets and liabilities of the joint venture if the investment in the joint venture is material.

Conclusion

The development of accounting principles over recent years has logically led to a demand for a larger degree of uniformity. A definition of the word "uniformity" suggests similar treatment of the same item occurring in many cases. In this sense the risk is run of concealing important differences among cases.

As mentioned early in this booklet, the accounting profession has been and is aware of divergencies in accounting. It also acknowledges that diversity of practice will continue as new practices are adopted before the old ones are discarded completely. It is hoped that the assembly in this booklet of the profession's present concepts of accounting principles for contractors will limit existing areas of difference in accounting practices, contribute to a better understanding of such principles, and result in improved presentations of financial statements of contractors.

Section II

AUDITING IN THE CONSTRUCTION INDUSTRY

Foreword

The examination of a contractor's statement of financial position and related statement of income presents many unique problems to the certified public accountant. This booklet has been prepared to set forth a guide to certain of the unusual auditing procedures the independent certified public accountant should consider in such an examination.

Auditing procedures are so numerous and must be varied so frequently to meet particular circumstances encountered with various contractors that it is not possible to enumerate procedures which would be applicable in every examination. Therefore, this booklet is not intended as a complete audit program but rather as a brief outline of the unusual features of an audit of a contractor's financial statements.

The committee wishes to acknowledge and express its appreciation for the assistance of Richard S. Hickok, research consultant, in the research and preparation of this booklet.

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AUDITING IN THE CONSTRUCTION INDUSTRY

Generally accepted auditing standards require a proper study and evaluation of existing internal controls as a basis for reliance thereon and to determine the extent of auditing tests and procedures which will be required. Prior to commencing an examination, the independent auditor should carefully review the contractor's internal controls and accounting procedures. While a review of this nature is not unusual to an examination of contractors' accounts, it is nevertheless an important consideration as the financial success of a contractor is often more dependent upon adequate internal controls, accounting records, and reliable interim financial statements than other types of business endeavors.

Internal control weaknesses and deficiencies in accounting records may frequently be noted in the following areas of a contractor's operations:

1. Failure to periodically evaluate contract profitability on a realistic basis
2. Inadequate control over estimating and bidding on new contracts
3. Inadequate contract cost records
4. Weaknesses in billing procedures
5. Inadequate control of construction equipment and lack of adequate cost records applicable to this equipment
6. Poor control of job site payrolls and other disbursements

In addition to this review of internal control, the nature of the construction industry is such that the independent auditor must have an intimate knowledge of the contractor's operation and a general understanding of the type of engineering and construction problems which may be encountered by the contractor. In addition, the independent auditor should be familiar with certain essential features of all major contracts currently in process or closed during the period.

To accomplish this, and before commencing the actual audit, the independent auditor should review all major contracts. Pertinent details should be extracted from the contract and the related contract files, and should be maintained in the independent auditor's permanent file for reference during the current audit (and subsequent examinations if contracts are of a long-term nature).

The independent auditor's contract file work papers should include the following information as a minimum.

a. Type of contract (i.e., excavation, grading, erection, engineering, etc.)
b. Contract price (i.e., fixed price, cost plus fixed-fee, guaranteed maximum price, etc.)
c. Escalation features, if any
d. Terms of payment
e. Cancellation features
f. Estimated costs by principal contract components and original estimated profit
g. Status as to renegotiation
h. Unusual contract features (such as penalty for failure to complete as scheduled, abnormal performance guarantees, bonus for early completion, etc.)
i. Bonding and insurance requirements
j. Equipment rental provisions

In the event the contractor is the prime contractor, and substantial portions of the project are to be undertaken by subcontractors, the independent auditor should also examine these contracts and prepare a similar record of their pertinent features for use in his examination.

Auditing difficulties are frequently encountered in the following areas:

1. Costs incurred on contracts in process (including field equipment), and related problems in connection with recognition of contract profits

2. Job sites
3. Raw materials and supplies
4. Accounts receivable (including retained percentages)
5. Accounts payable
6. Joint ventures

Contract costs

The major problem encountered in the examination of a contractor's financial position is in the audit of contracts in process. This is true whether the contractor's accounts are maintained on the percentage-of-completion basis, or on the completed-contract basis.

Many contractors will have several contracts in progress in varying stages of completion. The independent auditor is concerned with the determination of the status of each of the contracts in process as of the date of his examination.

The independent auditor should test the cost accumulated on contracts and be alert for items such as the following:

a. *Charges accumulated on cost-plus type contracts which are not reimbursable*—Such charges should be segregated on the contractor's cost records.

b. *Excessive charges for contractor's equipment used on the job site*—The contractor's accounting system should provide for charging contracts in process with the costs related to the equipment used on the project. The rates charged should be designed to absorb all applicable costs, including but not in excess of actual overhead. Frequently a contract will provide fixed rental for billing purposes, and the variance between these rates and actual contract costs should be considered in the independent auditor's evaluation of contract profitability.

c. *Charges for rented equipment, with option to buy*—Contractors often rent field equipment with option to buy, with the rental payments to apply against the purchase price. Equipment rental charges, and the related rental contracts, should be reviewed. Gross profit on contracts can be misstated by acquiring fixed assets in this manner and charging the entire cost against the contract. The independent auditor should review the circumstances relating to acquisition of construction equipment in this manner, and give due consideration to wear and tear on the equipment at the job site, estimated future life, fair market value, etc., in determining the propriety of the contractor's accounting treatment.

d. *The contractor's accounting policy with respect to overhead*—The overhead applied on engineering and manufacturing should not be in excess of actual overhead, and the latter should not include elements of idle plant expense, or other abnormal costs.

e. *The allocation of general and administrative overhead*—This allocation to contracts in process is occasionally justified to avoid distortion of the income of contractors using the completed-contract basis of recognizing income. Any such allocation, however, should be carefully reviewed by the independent auditor.

A contractor's accounting system should record job costs in such a manner that actual costs may be compared with original estimates used for bid purposes. This is helpful in projecting costs on contracts in process and to provide the basis for estimating accurately on future bids. The independent auditor should test the reliability of these detail cost records in connection with the above test of contract charges.

The independent auditor's review of contracts in process should be approximately the same regardless of the contractor's method of recording income. Before reviewing the status of each contract, the independent auditor should obtain a schedule of the following for all contracts in process:

Estimated total contract price
Contract billings to date
    Ratio

Estimated total contract cost (revised to date)
Estimated costs to complete contract
Costs accumulated to date
    Ratio of costs accumulated to date to estimated total contract costs

Original estimated contract profit
Revised estimated contract profit

Although the above information may not be easily available from the contractor's accounting records, it is a minimum required to determine the status of contracts in process.

This schedule will indicate contracts in varying stages of completion.

The audit of contracts recently accepted should include a review of the original bid estimate and estimated profit. The internal control review by the independent auditor of the estimating and bidding phase of the contractor's operation will indicate the extent of reliance the independent auditor may place upon these records. In addition, contract files will frequently indicate the bids entered by other contractors. Significant differences should be carefully investigated by the independent auditor.

In this connection, the independent auditor should investigate any contract which indicates an abnormally low rate of gross profit because of the possibility that such a contract may actually result in a loss. Any apparent loss contracts should be carefully reviewed with the contractor's engineering personnel and management to determine the losses which should be recorded.

If the contractor records earnings on a percentage-of-completion basis, the profit recognized on contracts in the early stages must, of necessity, be based on the original job estimate. However, until such time as it is possible to project contract costs with a reasonable degree of accuracy, care should be taken not to place unduly optimistic reliance on the original estimate of profit. Because of the problems connected with projecting costs to complete contracts, especially during the early stages of work on a contract, many contractors frequently defer recognition of profits on contracts until a sufficient amount of work has been performed so that a reasonably reliable determination can be made.

In the examination of contracts under way and those nearing completion, the independent auditor should review the estimated final profit on each contract. Costs accumulated to date and costs to complete all phases of the job should be projected by the contractor, and the total compared with the contract price. In reviewing these cost projections, the independent auditor should make tests of such records as the following:

a. Comparison of accumulated costs with original bid estimate, by individual item on original estimate

b. Commitment file for uncompleted subcontracting work

c. Open purchase order file

d. Independent architect's estimate of completion (if available)

e. Project engineer's estimate of completion

In addition to the above, contracts should be reviewed with the contractor's engineering personnel who are familiar with and responsible for the contracts in process. Engineering personnel should be informed as to the purpose of this review in order to obtain the utmost co-operation, and their comments should be given consideration in the evaluation of contract profits. However, the independent auditor should not accept client's estimates of contract profits without an independent review.

Most successful contracting companies regularly make extensive reviews of this nature in connection with the preparation of their interim financial statements. The results of these reviews as evidenced by their working papers should be utilized by the independent auditor in his examination.

In the event this review indicates that any contract will result in a loss, full provision should be made for these losses in the current period, regardless of the contractor's method of recognizing contract profits. However, if there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.[1]

After the determination of estimated contracts profits, the independent auditor must further ascertain that the correct amount of contract profit is recognized in the current period. In the event the contractor recognizes profits on a completed-contract basis, the independent auditor and the contractor must agree on what determines completion and apply this principle consistently from one accounting period to the next.

Contractors who recognize profits on a percentage-of-completion basis present an additional auditing problem, namely, the amount of earned billing and gross profit to recognize in the income statement. The method used by the contractor in recognizing contract profits and allocating those profits to income should measure actual contract performance in order to obtain a meaningful periodic allocation of income. For practical reasons contractors often recognize profits on purely arbitrary bases that may not have due regard for the work actually performed. Examples follow:

a. *Per cent billed to estimated total billings.* Due to contract terms, interim billings and cost incurred are not always comparable with each other, or with the actual percentage-of-contract completion. When contract billings run ahead of contracts costs and percentage of completion, due to "overbilling" and advance billings, the billing

[1]Accounting Research Bulletin No. 45, "Long-term Construction-type Contracts."

and the profit related thereto should not be included in the income statement. Billings not earned should be deducted from contracts costs and any remaining balance shown as a liability, under a caption indicating the nature of the account, such as "advance payments." Conversely, costs incurred and the extent of contract completion may justify the recognition of greater earnings than would be recognized under the billing-ratio method, and should also be evaluated by the independent auditor.

b. *Per cent costs incurred to estimate total costs.* In the event the contractor uses this method to measure contract performance for the purpose of determining the amount of income to allocate to the period, the independent auditor should ascertain that the results are meaningful and a true measure of actual contract completion. For example, the inclusion in costs of substantial amounts of material accumulated at the job site but not yet used would result in a larger amount of income allocable to the period than would be correct. Although the contractor may use such a basis to measure the amount of income to be recognized the independent auditor must ascertain that the results obtained from the method employed present a fair statement of actual operations in accordance with sound accounting principles.

Several of the problem areas in contract accounting arise from the practice employed by many contractors of recognizing profits on bases that do not measure actual contract completion. The independent auditor should inform management of the dangers inherent in preparing interim financial statements in this manner.

After completion of this review of the contracts, the independent auditor should also obtain a letter of representation from the company's financial and engineering management. This letter should set forth the methods employed by the company in accounting for contract profits and a résumé of the status of contracts in progress.

Other problems unique to particular fields of construction and particular types of contracts will be encountered on certain examinations, but the unique auditing problems remain constant; namely, the determination of gross profit, and the allocation of contract profits to periods for contractors using the percentage-of-completion basis.

Job sites

The magnitude and location of certain construction projects frequently necessitate the establishment of a contractor's office at the job site. A part of the contractor's accounting may often be performed at these offices. Depending upon the size and location of the project, this accounting work might include part or all of the following record-keeping and functions:

Payrolls

Labor distribution records

Purchasing

Payment of invoices

Cash receipts and disbursement records

Petty cash funds

Contract cost records

Field equipment records

Contract billings

In view of the temporary nature of these offices, the accounting procedures and records are often unsatisfactory and internal control may be weak or nonexistent. For these reasons, it is often desirable for the independent auditor to visit these offices, preferably on a surprise basis, to examine the accounting records and review the internal control procedures.

Payroll padding and loss or pilferage of construction equipment is a problem in the construction industry. For this reason the independent auditor should consider paying off personnel and making physical inventory tests of field equipment.

Large contractors engaging in many projects simultaneously will ordinarily have internal audit staffs who are responsible for auditing accounting records and procedures at the job sites. In these instances, the independent auditor should satisfy himself as to the scope of the internal audit programs and review the reports of their examinations during the period. In addition, the independent auditor should occasionally accompany the internal audit staff during an examination to evaluate the effectiveness of these audits.

Raw materials and supplies

The inventory of raw materials and supplies maintained by a contractor should be audited by use of the usual auditing procedures. Due to the nature of the construction industry, problems frequently arise in the following areas:

a. *Obsolescence and inactivity.* Technological advances in certain types of construction will often render obsolete substantial stocks of raw materials. The independent auditor should review stock activity, and discuss this problem with the contractor's engineering personnel.

b. *Excess materials on contracts.* The independent auditor should thoroughly review the contractor's procedure for accounting for the disposition of excess materials on contracts. The contractor should not accumulate an inventory of usable materials held at no value, and conversely unusable materials left over the completed contracts should not be included in the inventory. In addition to the problem of over- or understatement of raw material inventory, gross profit on completed contracts may be substantially misstated by the failure to establish an adequate procedure for accounting for this material.

c. *Usage of raw materials.* The charges to contract costs for raw materials will often represent both material purchased specifically for contracts in process and usage of materials carried by the contractor as raw materials and supplies. It is customary to charge contract costs with the value of materials purchased for a specific contract. However, with respect to charges to contract costs for the contractor's raw materials and supplies, the independent auditor should ascertain that these charges to contract costs represent materials actually placed in process (or physically segregated).

Accounts receivable

A contractor's receivables include amounts currently receivable on completed and uncompleted contracts, and retained percentages. The latter represent amounts withheld from payment by the paying agency and these amounts may be withheld until the job is completed or even longer in the event certain contract guarantees must be fulfilled prior to final acceptance.

The contractor's accounting records should provide for separate control accounts for these two types of receivables, inasmuch as retained percentages are subject to restrictive conditions. This is desirable for management, internal statements, and auditing purposes.

Trade receivables should be aged as of statement date. Similarly, retained percentages should be classified as due or not due. Delinquent balances should be very carefully investigated by the independent auditor through discussions with appropriate engineering personnel as well as financial management in order to ascertain whether any of the following problems exist:

a. Disputed costs billed on cost-plus type contracts

b. Certain types of billings to be revised to retain customer goodwill

c. Equipment is not meeting contract guarantees and "make-good" costs are anticipated

d. Amounts are not being billed in accordance with the contract

e. Contract cancellation, or postponement

f. Credit difficulties

The independent auditor should ascertain that adequate valuation reserves have been established for possible future adjustments such as set forth above.

The usual procedure of direct confirmation should be followed with respect to both amounts currently receivable and retained percentages.

The independent auditor must also make sufficient tests to ascertain that billings are being made in accordance with contract terms. In addition, he should ascertain by a test of billings that retained percentages are being billed and recorded as receivable, even though these amounts may not be currently due.

As previously mentioned, retained percentages are often not collected until the expiration of a guarantee period, or acceptance by the purchaser. The examiner should ascertain that adequate provision is made for fulfillment of related contract guarantees. The accrual for such expenditures may be deducted from retained percentages receivable (rather than being shown as a current liability) in the event they are not definite liabilities payable to a specific supplier or subcontractor.

Accounts payable relating to subcontractors

In the audit of accounts payable, the independent auditor should ascertain that this liability account includes both amounts currently due and retained percentages due to subcontractors. This would apply also to other principal suppliers who bill the contractor in this manner.

On a test basis, the independent auditor should reconcile statements received from major suppliers and subcontractors, if available, with the accounts payable records. Again, on a test basis, the independent auditor should request direct confirmation of balances due to some of the major creditors. The confirmation procedure is particularly desirable with respect to subcontractors. In addition to requesting confirmation of the liability due to the subcontractor as of the statement date, pertinent portions of the contract would ordinarily be confirmed.

The independent auditor should also determine that the voucher register has been held open for a sufficient period of time in order that billings from subcontractors for the final month of the period under examination may be recorded. This may be accomplished fairly simply if the independent auditor prepares a check-off list for subcontractors, and ascertains that the billing for the final period has been received and recorded.

Contracts with certain subcontractors may provide for billings based on percentages of completion rather than on a monthly basis. Due to the status of the work as of the statement date, no billing as of that date may be submitted by the subcontractor; the liability to such subcontractors should be recorded nevertheless. Contract status reports indicating the progress on each phase of the construction will be helpful to the independent auditor in determining the reasonableness of such accruals.

The detail trial balance of accounts payable should be thoroughly reviewed and older items investigated. These older balances may indicate that the contractor has offsetting claims against subcontractors for defective work, failure on performance guarantees, etc., which have not been recorded.

Joint ventures

Quite frequently two or more contractors undertake a construction project as a joint venture. In the event the contractor under examination is participating in such a venture, the independent auditor should review the joint venture agreement (similar in many respects to a partnership agreement). The joint venture agreement will supply the independent auditor with information with respect to the work to be undertaken by each party to the agreement, the method to be employed by each participant in charging contract costs to the joint venture, method of accounting for contract profit and losses, division of profit and losses between the participants, etc.

In addition, the related prime contract should also be reviewed and pertinent extracts noted, as discussed previously.

The contractor's investment in a joint venture is comparable to an investment in a subsidiary and, therefore, the auditing procedures to be employed for a joint venture are somewhat similar. The accounts of the joint venture should be examined, and most joint venture agreements provide for an annual audit and a final audit upon completion of the project. In the event the accounts of the joint venture are examined by other independent auditors, the independent auditor for the contractor should review the audited financial statements of the venture and should satisfy himself that the examination of the joint venture was made in accordance with generally accepted auditing standards.

An additional problem is present in those instances where the accounts and records of a joint venture are maintained by one of the other participating organizations and where these accounts and records are not subject to examination by an independent certified public accountant. The independent auditor must carefully consider the circumstances where these, or similar, conditions exist inasmuch as he may be precluded from expressing an unqualified opinion with respect to the financial statements, or may even find it necessary to disclaim an opinion.

In many respects the audit of a joint venture is comparable to the audit of the accounts of a contractor (see preceding sections); however, there is usually only one prime contract involved. However, as various phases of the project are usually separately handled by each of the participating contractors, they would invoice the joint venture with their portion of the work in accordance with the terms of the joint venture agreement.

In some instances the joint venture partnership may be merely a shell of an organization, with the major portion of contract costs arising from charges from the participating contractors. The independent auditor of the joint venture should ascertain that all billings are in accordance with the joint venture agreement. In order to do this, it may be necessary for him to examine supporting invoices, payrolls, and other records maintained by the various participants.

Generally accepted accounting principles for contractors recommend that there be adequate disclosure in the financial statements and related notes thereto with respect to a contractor's investment in joint ventures. The independent auditor should include this information in his report.

Conclusion

Upon completing the audit, and determining that the contractor's balance sheet and income statement fairly present the financial position and results of operations for the period, the independent certified public accountant has one further responsibility. That responsibility is to see that the statements, and related notes, set forth the contractor's financial position, and accounting policy, in accordance with generally accepted accounting standards, and in a manner comprehensible to the reader.

The form of the financial statements and the amount of detail shown will vary considerably according to the requirements of those who will receive them. It is important, therefore, for the certified public accountant to establish early in his examination how much detail will be required in the report by the various interested parties and to establish his audit program accordingly.

Section III

ILLUSTRATIVE CONTRACTOR FINANCIAL STATEMENTS AND INDEPENDENT AUDITORS' REPORTS

Introduction

The literature of the accounting profession as well as formal pronouncements by such regulatory bodies as the Securities and Exchange Commission makes it abundantly clear that management is responsible to creditors and stockholders for the substantial accuracy and adequacy of financial statements. The certified public accountant's representations are confined to and expressed in his report or opinion on the financial statements. The latter fact does not relieve the CPA of the responsibility of satisfying himself that informative disclosures are reasonably made in the financial statements. The CPA can, of course, improve financial statements and his advice as to the form and content of presentation is usually given great weight by his client.

Those in the construction industry, as well as others directly interested in it, such as sureties, bankers, governmental authorities and CPAs, have indicated the need for illustrative or "specimen" financial statements to supplement the AICPA literature previously published on this industry. The following "specimen" statements have been prepared to illustrate presentations under the two generally accepted methods of accounting (1) the "percentage-of-completion" method, and (2) the "completed-contract" method. Within this general framework slightly different styles have been illustrated. These styles can be used for either of the two generally accepted accounting methods.

No effort has been made to have either example encompass all possible presentations and varieties of transactions in this vast industry. It will be observed also that particular types of transactions are illustrated in one of the styles and not repeated in the other. However, one may find between the content of the two illustrations examples of many of the transactions or accounts typical of this industry as well as varied presentation techniques of such items as headings, dating and caption descriptions.

Although the accounting profession has generally adopted the short-form report or opinion for use with financial statements intended for publication, it is recognized that as to the construction industry, and in particular to the interested bankers and sureties, long-form reports serve a valuable purpose. The accompanying specimen statements have therefore been prepared in the "long form." In keeping with the standards recommended by Chapter 12, Long-Form Reports, of AICPA Statements on Auditing Procedure No. 33, each illustrated statement has been organized as follows:

(a) Basic financial statements with short-form opinion:

Opinion

Financial statements

Notes to financial statements

The information contained in the basic "short-form" presentation is presented as an entity containing complete financial statements without reference to the supplementary financial information.

(b) Additional financial information:

Opinion stating degree of responsibility assumed

Additional financial analyses, schedules and data

The information in this section may be submitted separately or it may be bound with copies of the report containing the "short-form" presentation as well. The additional financial information may be organized so that important items are set forth first and followed by details of miscellaneous accounts.

The organization of the illustrated statements is not intended to represent the only way of separating the basic financial statements from the additional information.

The independent auditor will have to exercise judgment as to whether the information necessary for adequate disclosure of financial position and results of operations is set forth in the basic financial statements and notes. The following excerpt from page 85 of Chapter 12 of Statements on Auditing Procedure No. 33 is pertinent:

> Where a long-form report is co-existing with a conventional short-form report the auditor should make sure that:
>
> a. the long-form report does not contain data which, if omitted from the short-form report, might support a contention that the short-form report was misleading because of inadequate disclosure of material facts known to the independent auditor; and
>
> b. none of the comments or other data contained in the long-form report lend themselves to a contention that they consti-

tute exceptions or reservations, as distinguished from mere explanations.

For users of financial statements, such as bankers and sureties, the information shown in the illustrations would be desirable, but they should not expect to see all of the situations and examples in every financial statement of a construction company that they review. In some instances, the information shown in the illustrations may be difficult to obtain with any degree of accuracy. In other instances, the expense of obtaining it may be too great in relation to the value that the reader might derive from it. With regard to the annual reports to stockholders, much of the detailed information of particular interest to bankers, sureties, etc., would not be necessary and, therefore, would be presented in less detail. Some of the data, however, may be set forth in the president's report or statistical section of the annual report.

The "percentage-of-completion" specimen (Percentage Construction, Inc.) illustrates:

(1) "balance sheet" presentation, including change order claims and taxes withheld
(2) a single corporate situation
(3) a statement of earnings, including contract losses reflected in costs and dividends being deducted from retained earnings
(4) footnotes which—
    (a) state joint venture investments and income for the year
    (b) indicate the declining balance depreciation method is employed for book and tax purposes
    (c) state that some field equipment is depreciated over a contract term
    (d) state that some of the company's business is renegotiable
(5) detailed presentation of joint ventures as separate statements
(6) funds statement in "change in working capital" form

The "completed contract" specimen (Completed Contractors Company, Inc.) illustrates:

(1) an auditor's report stating that the nonsponsored joint ventures were examined by other independent auditors
(2) a "statement of financial position" presentation, including restricted cash funds, bid deposits, receivables from officers and employees, land held for development, life insurance and pledged equipment
(3) a consolidated situation

(4) a statement of income, including contract losses displayed separately, as are sponsored and nonsponsored joint ventures, and dividends deducted from the year's income, and
(5) footnotes which—
    (a) state the consolidation principles
    (b) indicate nonsponsored joint ventures observing a different accounting method
    (c) indicate contingent assets and liabilities
(6) summary of contract work and backlog by area
(7) funds statement showing changes in current assets and liabilities

In the "specimen" reports it will be observed that only a few exhibits typical of this industry have been illustrated for the purpose of suggesting form and content under the two methods of accounting. In actual practice the additional financial section may include such items as:

brief financial review or summary (financial highlights)
analysis of major income statement items and comparison of amounts and ratios with prior year or years
analyses of receivables (as to aging or collectibility) and related allowances
analyses of fixed assets and related accumulated depreciation
summary of insurance coverage
summary of income tax status
information regarding capital or financial transactions
details of other balance sheet items
other special information

The above suggested list is neither intended to be all-comprehensive nor to have been arranged in an order of importance or frequency.

Percentage Construction, Inc.

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JOHN DOE & CO.
Certified Public Accountants
City, State

To the Stockholders and
Board of Directors of
Percentage Construction, Inc.

We have examined the balance sheet of Percentage Construction, Inc., as of December 31, 1964, and the related statement of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet and statement of income and retained earnings present fairly the financial position of Percentage Construction, Inc., as of December 31, 1964, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

JOHN DOE & CO.

Certified Public Accountants

February 27, 1965

Percentage Construction, Inc.
Comparative Balance Sheets
December 31, 1964 and 1963

ASSETS

	December 31, 1964		*December 31, 1963*	
Current Assets:				
Cash	$	$ 205,874	$	$ 184,697
Accounts receivable:				
Due on contracts, including amounts retained by customers in accordance with contract provision (1964, $97,432; 1963, $92,589), less allowance of $10,000 (1964 and 1963) for uncollectible accounts	251,433		247,328	
Claims for approved contract change orders on completed contracts	61,030		—	
Other	1,406	313,869	3,277	250,605
Costs and estimated earnings in excess of billings on uncompleted contracts (Note 2)		386,681		463,068
Inventory of materials and supplies not allocable to contracts in process (valued at lower of average cost or market)		58,312		57,900
Investment in joint ventures (Note 3)		51,111		10,100
Prepaid expenses		43,989		45,610
Total current assets		$1,059,836		$1,011,980
Plant, property, and equipment (Note 4)		304,108		298,305
Other assets		1,020		1,422
		$1,364,964		$1,311,707

See accompanying notes to financial statements.

LIABILITIES AND CAPITAL

	December 31, 1964		December 31, 1963	
Current Liabilities:				
5% unsecured notes payable to banks	$	$ 50,000	$	$ 50,000
Accounts payable and unbilled amounts due subcontractors, and others (including amounts retained — 1964, $125,654; 1963, $110,592)		243,534		211,890
Withheld from employees (taxes and sundry)		4,201		3,228
Billings in excess of costs and estimated earnings (Note 2)		332,211		342,021
Accrued expenses:				
Federal and state income taxes	73,431		87,749	
Other	8,769	82,200	6,053	93,802
Total current liabilities		712,146		700,941
Capital stock and retained earnings:				
Common stock: 2,500 shares authorized, par value $100; 2,106 shares issued and outstanding at both dates	210,600		210,600	
Retained earnings	442,218	652,818	400,166	610,766
Contingent liabilities (Note 5)				
		$1,364,964		$1,311,707

Percentage Construction, Inc.
Comparative Statements of Income and Retained Earnings
Years Ended December 31, 1964 and 1963

	1964	*1963*
Earned revenues	$1,953,308	$1,910,598
Cost of earned revenues (including accrued losses on contracts—1964, $45,000; 1963, $12,500)	1,748,599	1,699,110
Gross profits from operations (Note 1)	204,709	211,488
Earnings from joint ventures (Note 3)	11,011	2,100
Total gross profit	215,720	213,588
Selling, general, and administrative expenses	55,127	57,384
Income from operations	160,593	156,204
Other income	4,231	3,698
	164,824	159,902
Other deductions (including interest—1964, $2,500; 1963, $1,250)	3,432	2,115
Income, before provision for income taxes	161,392	157,787
Provision for Federal and state income taxes	81,432	80,132
NET INCOME FOR YEAR	79,960	77,655
Retained earnings, beginning of year	400,166	359,366
	480,126	437,021
Dividends paid on common stock—(1964, $18.00 per share; 1963, $17.50 per share)	37,908	36,855
Retained earnings, end of year	$ 442,218	$ 400,166

See accompanying notes to financial statements.

Percentage Construction, Inc.
Notes to Financial Statements
December 31, 1964

Note 1—Accounting Basis for Recording Income

Profits on long-term contracts are recorded on the basis of the company's estimates of the percentage of completion of individual contracts, commencing when progress reaches a point where experience is sufficient to estimate final results with reasonable accuracy. That portion of the total contract price is accrued which is allocable, on the basis of the Company's engineering estimates of the percentage of completion, to contract expenditures incurred and work performed.

As these long-term contracts extend over one or more years, revisions in cost and profit estimates during the course of the work are reflected in the accounting period in which the facts which require the revision become known.

Profits on short-term contracts are recorded on the substantial completion of each contract.

At the time a loss on a contract becomes known, the entire amount of the estimated ultimate loss on both short- and long-term contracts is accrued.

Notes (continued)

Note 2—Contracts in Process

Comparative information with respect to contracts in process follows:

	December 31			
		1964		*1963*
Expenditures on uncompleted contracts	$	$1,566,438	$	$1,602,322
Estimated earnings thereon (net of accrued losses in the amount of $45,000 and $12,500, respectively)		244,860		188,650
		1,811,298		1,790,972
Less billings applicable thereto		1,756,828		1,669,925
		$ 54,470		$ 121,047
Included in accompanying balance sheet under following captions:				
Costs and estimated earnings in excess of billings on uncompleted contracts	386,681		463,068	
Billings in excess of costs and estimated earnings	$332,211	$ 54,470	$342,021	$ 121,047

Notes (continued)

Note 3—Joint Ventures

The Company is a participant with other contractors in long-term contracts undertaken as joint ventures. The Company's investment in joint ventures is stated at cost plus the equity in unremitted earnings of the various ventures. Summary information, based on latest available financial statements, with respect to the joint ventures follows:

Current assets	$245,430
Current liabilities	98,663
Working capital	146,767
Construction equipment (net of accumulated depreciation)	64,343
Net assets	$211,110
Company's equity in net assets of ventures	$ 51,111
Participation in earnings of joint ventures during the year ended December 31, 1964	$ 11,011

The venture accounts are maintained on a percentage of completion basis, and contract profits and losses are recorded substantially as set forth in Note 1.[a]

[a] In the event audited financial statements of the venture accounts are not available or are not reasonably current, the independent auditor may have to qualify or disclaim an opinion with respect to the financial statements of Percentage Construction, Inc., if the amounts applicable to the ventures are material. See also paragraphs 32-36 of Chapter 10 of Statement on Auditing Procedure No. 33, with respect to reporting on utilization of reports of other independent auditors.

Note 4—Plant, Property and Equipment

A summary of the plant, property and equipment and accumulated depreciation is as follows:

	Cost	*Accumulated Depreciation*	*Net*
Land	$ 30,323	$	$ 30,323
Buildings	222,935	175,231	47,704
Plant machinery and equipment	251,776	179,455	72,321
Field construction equipment	383,589	233,261	151,328
Office equipment	7,634	5,202	2,432
	$896,257	$592,149	$304,108

The provision for depreciation of fixed assets charged to costs and contract expenditures totaled $49,653 for the year ended December 31, 1964, and $45,892 for the previous year.

Fixed assets, other than field construction equipment, are depreciated over their estimated useful lives on a declining-balance method for both book and tax purposes.

Field construction equipment is depreciated over the estimated useful life of the equipment to the Company, which in some instances is the term of a particular contract.

In accordance with trade practice, field construction equipment has been leased for various projects in process. Certain of these rental contracts include an option to purchase the equipment, and Management may in the future exercise certain of these options to meet the normal requirements of the business.[b]

[b] The independent auditor should determine that the accounting for leased construction equipment is in conformity with Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee," of the Accounting Principles Board of the AICPA.

Notes (continued)

Note 5—Contingent Liabilities

A substantial portion of the Company's business is with the departments and agencies of the United States and is subject to renegotiation and to redetermination at the convenience of the Government. It is the opinion of Management that the renegotiation and redetermination of long-term contracts will have no material effect on the Company's financial position or results of operations for the period.

JOHN DOE & CO.
Certified Public Accountants
City, State

To the Stockholders and
Board of Directors of
Percentage Construction, Inc.

The primary purpose of our examination was to formulate an opinion on the financial statements of Percentage Construction, Inc., for the year ended December 31, 1964, taken as a whole. The accompanying additional financial information, while not considered necessary for a fair presentation of financial position and results of operations, is presented for supplementary analysis purposes. Our examination of the financial statements for the year ended December 31, 1964, covered by our opinion in the first section of this report, was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records from which the additional financial information was compiled and such other procedures as we considered necessary in the circumstances.

In our opinion, such additional financial information is presented fairly in all material respects in relation to the financial statements, taken as a whole, of Percentage Construction, Inc., for the year ended December 31, 1964.

JOHN DOE & CO.

Certified Public Accountants

February 27, 1965

Percentage Construction, Inc.
Schedule "A"
Amounts Due on Contracts
December 31, 1964

	Contract Billings			
Project	*Completed Contracts*	*Progress Billings on Uncompleted Contracts*	*Total*	*Retentions Not Currently Due*
Summarize by project	$	$	$	$
Total	$62,500	$198,933	$261,433	$97,432

NOTE—The allowance for uncollectible accounts in the amount of $10,000 is not deducted in the above schedule.

Percentage Construction, Inc.
Schedule "B"
Contracts in Process
December 31, 1964

Project	*Total Contract Price*	*Estimated Total Contract Profit (Loss)*	*Contract Expenditures to December 31, 1964*
(Summarize by project, briefly describing each project, and noting type of contract — "cost plus," "fixed fee," etc.)	$	$	$
	$2,753,000	$422,333	$1,566,438

NOTE—The backlog of contracts not started at December 31, 1964, totaled approximately $2,000,000 as compared with $1,700,000 a year earlier.

Contract Profit (or Loss) Accrued to December 31, 1964	*Billings to December 31, 1964*	*Costs and Estimated Earnings in Excess of Billings*	*Billings in Excess of Costs and Estimated Earnings*
$	$	$	$
$244,860	$1,756,828	$386,681	$332,211

Percentage Construction, Inc.
Schedule "C"
Venture Operations
Year Ended December 31, 1964

Project	*Date of Latest Audited Financial Statements*	*Current Assets*	*Current Liabilities*	*Working Capital*	*Construction Equipment (Net)*	*Net Assets*	*Venture Total Contract Amount*
Sponsored ventures: (Summarize by venture, briefly describing each venture)		$	$	$	$	$	$
Ventures sponsored by others: (Summarize by venture, briefly describing each venture)							
		$245,430	$98,663	$146,767	$64,343	$211,110	$1,150,000

SEE EXPLANATORY NOTES to Schedule C on page 80.

Accounts			*Investment in Joint Ventures*			*Income from Joint Ventures*	
Earned Revenues	*Cost of Earned Revenues*	*Income for Period*	*Advances*	*Equity in Unremitted Income Earned*	*Total*	*Per Cent of Participation in Venture Income*	*Equity in Income for Period*
$	$	$	$	$	$		$
$262,500	$218,250	$44,250	$38,000	$11,011	$51,111		$11,011

It will be noted that long-term assets represent a substantial proportion of the net assets of the joint ventures in both cases, but that the joint ventures are classified, for illustrative purposes, as current assets in the case of Percentage Construction, Inc., and as noncurrent assets in the case of Completed Contractors Company, Inc. Ordinarily, in view of their materiality, the equipment portion of the investment in joint ventures would be classified as noncurrent in both cases.

There are, however, some contractors who enter into joint ventures for the completion of projects of limited duration. Upon completion of these contracts all of the assets in the joint ventures are liquidated and the proceeds distributed to the venturers. These contracts would be no different under the "normal operating cycle" concept than regular contracts, assuming the contractor's other contracts were of similar duration. On this basis, the investment in the joint venture could be considered as a current asset.

On the other hand, some contractors have formed permanent joint ventures, as for example, for the purposes of bidding on missile sites. These ventures sometimes are in the form of a partnership, or of a corporation. It is not their intent to dissolve the venture and distribute the assets at the conclusion of a particular contract because they intend to go on bidding and performing these contracts as long as the Government continues its space program. This type of venture would be considered as a long-term investment and not classified as a current asset.

Percentage Construction, Inc.
Schedule "D"
Cost of Earned Revenues
For Years Ended December 31, 1964 and 1963

	1964	*1963*
Engineering and drafting*	$	$
Manufacturing costs*		
Field supervision		
Field labor		
Equipment costs*		
Subcontractor costs		
Etc.		
	$1,748,599	$1,699,110

Explanatory Notes:

* Depending upon the contractor's method of accounting for such items as engineering, drafting, manufacture of components for contracts, field equipment, etc., over (or under) absorbed overhead may be included in the cost of earned billings. Supplemental schedules setting forth this information may be appropriate in the circumstances. See Schedule "E" attached.

In addition, depending upon the contractor's volume and accounting records, the above schedule also could be set forth by major contracts.

Percentage Construction, Inc.
Schedule "E"
Engineering and Drafting, Manufacturing and Equipment Costs
For Years Ended December 31, 1964 and 1963

	1964		
	Engineering and Drafting	*Manufacturing*	*Equipment*
Salaries:			
Drafting	$	$	$
Indirect labor			
Supervision			
Employee benefits			
Maintenance and repairs			
Etc.			
Total	$118,300	$602,300	$137,500
Less:			
Amounts charged to contract costs	$115,000	$618,000	$128,625
Income from equipment rentals			20,000
	$115,000	$618,000	$148,625
Net over (under) absorbed costs	($ 3,300)	$ 15,700	$ 11,125

	1963			
Total	*Engineering and Drafting*	*Manufac-turing*	*Equipment*	*Total*
$	$	$	$	$
$858,100	$125,025	$622,030	$150,200	$897,255
$861,625	$120,000	$632,050	$130,200	$882,250
20,000			30,000	30,000
$881,625	$120,000	$632,050	$160,200	$912,250
$ 23,525	($ 5,025)	$ 10,020	$ 10,000	$ 14,995

Percentage Construction, Inc.
Schedule "F"
Selling, General and Administrative Expenses
For Years Ended December 31, 1964 and 1963

	1964			*1963*		
	Selling	*General and Administrative*	*Total*	*Selling*	*General and Administrative*	*Total*
Salaries:						
Officers	$	$	$	$	$	$
Sales engineers						
Office						
Rent						
Etc.						
	$17,327	$37,800	$55,127	$15,360	$42,024	$57,384

Percentage Construction, Inc.
Schedule "G"
Other Income and Other Deductions
For Years Ended December 31, 1964 and 1963

	1964	*1963*
Other income:		
Net gain on disposal of equipment	$	$
Interest		
Etc.		
	$4,231	$3,698
Other deductions:		
Interest	$	$
Etc.		
	$3,432	$2,115

Percentage Construction, Inc.
Schedule "H"
Statement of Funds Provided and Applied
For Years Ended December 31, 1964 and 1963

	1964	*1963*
Funds were provided as follows:		
Net earnings for year	$ 79,960	$ 77,655
Add deductions made in determination of net earnings which do not represent an expenditure of funds:		
Provision for depreciation	49,653	45,892
Write-off on disposal of fixed assets	6,202	404
Decrease in other assets	402	—
	$136,217	$123,951
Application of funds provided:		
Dividends paid	$ 37,908	$ 36,855
Additions to property, plant and equipment	61,658	33,561
	$ 99,566	$ 70,416
Net increase in working capital	$ 36,651	$ 53,535

Completed Contractors Company, Inc.
Index

RICHARD ROE & COMPANY
Certified Public Accountants

City
State
January 15, 1965

To the Board of Directors of
Completed Contractors Company, Inc.

We have examined the consolidated statement of financial position of Completed Contractors Company, Inc., and its wholly owned subsidiary companies at November 30, 1964, and the related consolidated statement of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of the joint ventures not sponsored by the Company which were examined by other certified public accountants whose reports have been furnished to us. Our opinion expressed herein, insofar as it relates to the amounts included in the accompanying financial statements regarding joint ventures sponsored by others, is based solely upon such reports.

In our opinion, the accompanying statements present fairly the consolidated financial position of Completed Contractors Company, Inc., and its wholly owned subsidiary companies at November 30, 1964, and the results of their operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.**

RICHARD ROE & COMPANY

(Signed)

Certified Public Accountants

**See paragraph 34 of Chapter 10 of Statements on Auditing Procedure No. 33 for alternative wording of report.

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies

(Incorporated in Iowa)

Consolidated Statement of Financial Position At November 30

	1964	1963
CURRENT ASSETS:		
Cash	$ 262,509	$ 406,158
Cash restricted to use on a particular contract	64,000	150,000
Accounts receivable, less allowance of $15,000 for doubtful accounts:		
Completed contracts including retentions	268,176	204,910
Uncompleted contracts:		
Progress billings	498,611	610,860
Retentions withheld until completion	359,249	280,560
Refundable bid deposit	30,000	—
Due from officers and employees	2,826	2,500
Costs of uncompleted contracts in excess of billings and billings accrued of $2,411,007 (1964), $2,413,800 (1963) (Note C)	385,713	112,630
Inventories, at lower of average cost or market:		
Building materials	142,014	72,640
Other materials and operating supplies	104,113	61,432
Prepaid expenses	56,152	55,816
	2,173,363	1,957,506
LESS—CURRENT LIABILITIES:		
Notes payable to bank, unsecured	10,000	10,000
Current maturities of equipment purchase obligations	14,000	8,000
Mortgage installment payable	3,000	3,000
Accounts and subcontracts payable	511,101	268,326
Accrued salaries, wages and bonuses	19,600	12,612
Estimated Federal income taxes	214,556	41,014
Other accrued expenses and withheld taxes	32,611	20,746
Billings and billings accrued on uncompleted contracts in excess of costs of $2,317,612 (1964), $1,941,011 (1963) (Note C)	752,336	973,515
Estimated losses on uncompleted contracts (Note C)	50,000	—
Retentions withheld from subcontractors until completion	237,405	229,265
	1,844,609	1,566,478
Working capital	$ 328,754	$ 391,028
Current ratio	1.18 to 1	1.25 to 1

(continued on page 90)

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies

(Incorporated in Iowa)

Consolidated Statement of Financial Position At November 30

	1964	1963
WORKING CAPITAL, brought forward	$ 328,754	$ 391,028
INVESTMENTS:		
Land held for development at cost	10,603	10,603
Joint ventures (Note D):		
Advances	25,000	25,000
Equity in unremitted income earned	129,800	55,870
Cash surrender value of life insurance	7,807	5,373
	173,210	96,846
PROPERTY AND EQUIPMENT, at cost (Note E):		
Construction equipment — pledged $76,500 (1964), $46,800 (1963)	149,249	88,519
Automobiles and trucks	52,768	26,244
Office furniture and equipment	23,211	16,269
Office building	63,620	55,620
	288,848	186,652
Less — Depreciation to date	98,977	63,921
	189,871	122,731
Land	15,000	15,000
	204,871	137,731
LESS — LONG-TERM OBLIGATIONS (Note E):		
5% unsecured serial notes payable to bank, $10,000 payable annually to January 15, 1966	30,000	40,000
6½% equipment purchase obligations	46,000	30,000
5½% mortgage payable, due in 1975	36,000	39,000
	112,000	109,000
Excess of assets over liabilities	$ 594,835	$ 516,605
Represented by:		
Stockholders' equity:		
Common stock, par value $1 per share — authorized and outstanding 19,500 shares, including excess over par	$ 161,960	$ 161,960
Retained earnings (Note A)	432,875	354,645
	$ 594,835	$ 516,605

See notes to consolidated financial statements.

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies

(Incorporated in Iowa)

Consolidated Statement of Income and Retained Earnings For the Year Ended November 30

	1964	*1963*
Billings to customers under completed contracts (Note B)	$6,122,855	$3,564,441
Direct contract costs	5,625,946	3,346,576
	496,909	217,865
Less — Provision for losses on uncompleted contracts (Note C)	50,000	—
	446,909	217,865
Other income:		
Share of income from joint ventures (Note D):		
Sponsored ventures [share of gross billings $2,552,050 (1964), $1,984,600 (1963)]	51,031	49,615
Ventures sponsored by others [share of gross billings $1,920,275 (1964), $2,521,603 (1963)]	56,811	26,385
Income from equipment rentals (net)	24,693	15,795
Interest income	5,538	2,605
Gain on sale of equipment (net)	14,120	—
	599,102	312,265
Indirect costs and administrative expenses, including interest of $9,031 (1964) and $8,562 (1963)	206,872	141,917
	392,230	170,348
Estimated Federal and state income taxes (Note B)	197,000	73,000
NET INCOME FOR THE YEAR	195,230	97,348
Cash dividends on common stock of $6.00 (1964) and $3.50 (1963)	117,000	68,250
	78,230	29,098
Retained earnings at beginning of year	354,645	325,547
Retained earnings at end of year (Note A)	$ 432,875	$ 354,645

See notes to consolidated financial statements.

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies Notes to Consolidated Financial Statements

Note A—Principles of Consolidation:

The consolidated financial statements include the accounts of Completed Contractors Company, Inc., and the following subsidiary companies, all of which are wholly owned:

126 Houston Avenue Corporation—building corporation
Equipment, Incorporated—construction equipment rentals
Bonanza Corp.—real estate development company

All intercompany items and transactions have been eliminated in the preparation of the consolidated statements.

As at November 30, 1964, the company's equity in the net assets of its consolidated subsidiary companies, as shown by the books of such companies, exceeded the carrying value of the company's investments in such subsidiary companies by an amount of $80,140 which in consolidation has been added to retained earnings, representing earnings of subsidiaries since their formation.

Note B—Accounting Basis for Recording Income:

The company records profits or losses on its short- and long-term contracts on the "completed-contract" method. Under this method, billings (including estimates of amounts billable for work already performed) and costs are accumulated during the period of construction, but no profits are recorded before the substantial completion of the work (usually approximately 95% completion). For purposes of determining taxable income, profits are reflected when work is both completed and accepted. The provision for estimated Federal and state income taxes included $62,500 applicable to profits not taxable in the current year. When estimates indicate a probable ultimate loss on a contract, the full amount thereof less the related future income tax reduction, is accrued. Indirect costs and administrative expenses are charged as incurred to periodic income and are not allocated to contract costs.

Notes (continued)

Note C—Contracts in Progress:

Information relative to contracts in progress at November 30, 1964 and 1963, follows:

	1964	*1963*
Billings including estimated billings accrued of $410,000 (1964), $540,000 (1963)	$5,480,955	$5,328,326
Accumulated costs	5,114,332	4,467,441
	$ 366,623	$ 860,885

	1964	*1963*
Included in the accompanying financial statements in:		
Current liabilities[1]	$752,336*	$973,515
Current assets	385,713	112,630
	$366,623	$860,885

*Does not include provisions for losses commented on in the next paragraph.

During 1964 the company encountered unforeseen conditions on two fixed price contracts totaling $850,000 indicating final cost overruns of approximately $116,000. About $100,000 of this amount relates to the Deep Pit Foundation Contract for $800,000 on which unanticipated subsurface water conditions have been experienced. Provisions for these losses, less the estimated future income tax reductions of $66,000, have been made in the amount of $50,000 in the accompanying financial statements. No further losses are presently foreseen by the company's engineering staff.

It is the practice of the companies not to reflect change orders and claims in the financial statements until approved and the compensation agreed upon. Company officials and counsel estimate approved orders and claims relating to work already performed at approximately $175,000 at November 30, 1964, of which approximately $80,000 would be payable to subcontractors.

[1] Paragraph 12 of Accounting Research Bulletin No. 45 states that "When the completed contract method is used, . . . an excess of accumulated billings over related costs should be shown among the liabilities, *in most cases as a current liability.*" [Italics supplied.] The phrase "in most cases" was inserted as a recognition of the possibility of situations arising in which it would be unreasonable to require the entire amount of the excess to be treated as a current liability. In such cases, a "suspense" or "deferred credit" category could properly be used for the profit element. [See *Journal of Accountancy,* February 1956, page 63.]

Note D—Joint Ventures:

The company is sponsoring two long-term joint ventures in which its participation is 40 to 35% and its subsidiary is sponsoring one in which its participation is 45%. All sponsored ventures have the same fiscal year as the company. The ventures which the company sponsors record profits on the "completed-contract" method, and the subsidiary-sponsored venture records profits on the "percentage-of-completion" method. The company also participates with others in two additional joint ventures to the extent of 10 and 25%. These ventures sponsored by others recognize profits on the "percentage-of-completion" method.

Investments in joint ventures are stated at cost plus the equity in unremitted income earned. Combined comparative summary information from the latest audited venture financial statements is as follows:[2]

	1964	*1963*
Current assets	$1,507,928	$ 662,193
Current liabilities	950,022	418,886
Working capital	557,906	243,307
Fixed and other assets	226,105	176,803
Net assets	$ 784,011	$ 420,110
Equity in net assets, represented by advances and unremitted income	$ 154,800	$ 80,870
Equity in earnings for the year	$ 107,842	$ 76,000

Note E—Properties, Depreciation Policy and Long-term Obligations:

Construction equipment, automobiles and trucks are owned by Equipment Incorporated, a subsidiary, which is engaged in the rental business. This subsidiary, which largely services the company, also rents equipment to the public. Certain of the construction equipment is pledged to secure serial purchase notes presently payable at a rate of $14,000 per annum. Most of the equipment is being depreciated over

[2] In the event audited financial statements of the venture accounts are not available or are not reasonably current, the independent auditor may have to qualify or disclaim an opinion with respect to the financial statements of Completed Contractors Company, Inc., if the amounts applicable to the ventures are material. See paragraphs 32-36 of Chapter 10 of Statements on Auditing Procedure No. 33 with respect to utilization of reports of other independent auditors.

an estimated useful life of six years and the automobiles and trucks over an estimated life of four years on the straight-line basis. Equipment is also leased for varying periods of time by the company and its subsidiaries; in accordance with trade practice a portion of this rented equipment is under options to purchase by the company and its subsidiaries, percentages of rentals being allowable toward the purchase prices.[3]

The office building and the related land, solely occupied by the company and its subsidiaries, are owned by 126 Houston Avenue Corporation, a subsidiary. This building is subject to a self-liquidating mortgage being amortized as to principal at the rate of $3,000 per annum through 1976. The office building is being depreciated on the straight-line basis over an estimated thirty-five year life.

Depreciation on construction equipment, autos and trucks is allocated to contracts in progress based on usage. Total depreciation charged during 1964 and 1963 was as follows:

	1964	*1963*
Office furniture, equipment and building	$ 4,000	$ 4,000
Construction equipment, autos and trucks	34,000	18,000
	$38,000	$22,000

Of the total depreciation charges approximately $31,000 and $8,000, respectively, related to contracts completed in 1964 and 1963.

Note F—Contingent Liabilities:

There are claims, totaling $128,000, pending against the company and two bonding companies arising out of the failure of a subcontractor of the company to pay its suppliers. There are three lawsuits pending on these claims. In the opinion of counsel and the company's management the outcome of this litigation will not have a material effect on the financial position of the company.

[3] The independent auditor should determine that the accounting for leased construction equipment is in conformity with Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee," of the Accounting Principles Board of the AICPA.

RICHARD ROE & COMPANY
Certified Public Accountants

City
State
January 15, 1965

To the Board of Directors of
Completed Contractors Company, Inc.

OPINION ON ADDITIONAL FINANCIAL INFORMATION

The primary purpose of our examination was to formulate an opinion on the consolidated financial statements of Completed Contractors Company, Inc., and its wholly owned subsidiary companies, taken as a whole, for the year ended November 30, 1964, and the accompanying additional financial information, while not considered necessary to a fair presentation of the financial position and results of operations, is presented for supplementary analysis purposes. In our opinion, except as set forth in the succeeding sentence, such information is presented fairly in all material respects in relation to the consolidated financial statements, taken as a whole, of Completed Contractors Company, Inc., and its wholly owned subsidiary companies for the year ended November 30, 1964, which are covered by our opinion presented in the first section of this report. We do not express an opinion on estimates of ultimate profits on contracts in progress, nor estimates of future costs and revenues used in the derivation thereof presented in Exhibit I. Inasmuch as the basic financial statements are prepared on the completed contract method, our examination of estimated costs to complete contracts in progress was designed to give reasonable assurance that, where ultimate losses on contracts are currently indicated, reasonable estimates of such losses are recorded. Our examination was not sufficient, however, to enable us to express an opinion on the fairness of the estimates of ultimate profitability of individual contracts in progress. In all other respects, our examination of the additional financial information included such tests of the accounting records from which it was compiled and such other procedures as we considered necessary in the circumstances.

RICHARD ROE & COMPANY

(Signed)

Certified Public Accountants

NOTE—The underlined comments above may be omitted when an unqualified opinion is appropriate.

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies
Statement of Contracts in Progress
At November 30, 1964

	For the entire contract		
Project	*Contract price (including change orders) approved as to compensation*	*Estimated direct costs*	*Estimated profit (loss) to be realized* (1)
Projects on which costs exceed billings:			
(Summarize by project, briefly describing each project and note type of contract—"cost plus," "fixed fee," etc.	$	$	$
Total	$4,398,611	$3,807,243	$591,368
Projects on which billings exceed costs:			
(Summarize by project, briefly describing each project and note type of contract—"cost plus," "fixed fee," etc.	$	$	$
Total	$3,894,562	$3,320,571	$573,991

See accompanying notes to Exhibit 1.

EXHIBIT I

Status at November 30, 1964					
Estimated amount collectible on change orders unapproved as to compensation (2)	*Billings to date*	*Direct costs to date*	*Difference between billings and costs*	*Balance of contract price to be billed*	*Estimated direct costs to complete*
$	$	$	$	$	$
$68,000	$2,411,007	$2,796,720	($385,713) (3)	$1,987,604	$1,010,523
$	$	$	$	$	$
$27,000	$3,069,948	$2,317,612	$752,336 (3)	$ 824,614	$1,002,959

Notes to Exhibit I

(1) See Note C to the financial statements for comments on the provision for losses on contracts in progress. Loss contracts totaling $116,000 are identified with an asterisk (*).

(2) The amounts are shown net of amounts payable to subcontractors. See Note C to the financial statements for additional commentary.

(3) Does not include provisions for losses of approximately $116,000 commented on in Note C to the financial statements.

(4) A summary of the companies' completed and uncompleted contract volume, exclusive of their proportionate share of joint venture contracts, is noted below:

			Total	
	Midwest	*Southwest*	*1964*	*1963*
Unbilled and uncompleted work carried over	$3,800,000	$5,400,000	$ 9,200,000	$14,300,000
New work awarded during the year	500,000	3,100,000	3,600,000	7,100,000
Total volume in force	4,300,000	8,500,000	12,800,000	21,400,000
Less—Billings relating to work performed during the year	3,700,000	6,300,000	10,000,000	12,200,000
Backlog—Unbilled and uncompleted work at November 30	$ 600,000	$2,200,000	$ 2,800,000	$ 9,200,000

One new contract award of approximately $900,000 has been received since November 30, 1964. The companies' proportionate share in the backlog of uncompleted joint venture work was $1,600,000 at November 30, 1964, and $6,100,000 at November 30, 1963. No new joint ventures were entered into during the 1964 fiscal year.

EXHIBIT II

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies Statement of Contracts Completed During Year Ended November 30, 1964

(including additional billings and costs under contracts completed in prior periods)

Project	*Gross billings to customers*	*Direct contract costs*	*Gross income before indirect costs and income taxes*
(Summarize by project, briefly describing each project and note type of contract — "cost plus," "fixed fee," etc.)	$	$	$
Total	$6,122,855	$5,625,946	$496,909

EXHIBIT III

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies Statement of Indirect Costs and Administrative Expenses For the Year Ended November 30, 1964

	1964	*1963*
Salaries—officers	$	$
Office salaries		
Office maintenance, etc.		
Total	$206,872	$141,917

EXHIBIT IV

Completed Contractors Company, Inc., and Wholly Owned Subsidiary Companies Consolidated Statement of Source and Application of Funds For the Year Ended November 30, 1964

	1964	*1963*
Funds were provided by—		
Net income for the year	$195,230	$ 97,348
Depreciation, not requiring funds	35,056	22,786
Funds provided by operations	$230,286	$120,134
Additional unpaid accounts and other payables	435,170	10,837
Increase in equipment purchase obligations	22,000	12,500
Decrease in free and restricted cash balances	229,649	—
Reduction in withheld retentions	—	43,853
Collections of accounts receivable	18,657	87,564
Total	935,762	274,888
Funds were applied to—		
Cash dividends	117,000	68,250
Contracts in process	444,262	98,265
Inventory materials and prepaid expenses	112,391	6,523
Repayments of serial obligations	13,000	10,000
Equipment and other property purchased	102,196	13,786
Investment in joint ventures and life insurance	76,364	2,382
Increase in free and unrestricted cash balances	—	75,682
Additional withheld retentions	70,549	—
Total	$935,762	$274,888